(21)

ANNUAL REPORT TO PARLIAMENT

ON THE OPERATIONS OF THE

EXCHANGE FUND ACCOUNT

BY THE MINISTER OF FINANCE

AND

REPORT OF THE AUDITOR GENERAL

TO THE MINISTER OF FINANCE

ON THE EXAMINATION OF THE

ACCOUNTS AND FINANCIAL STATEMENTS

OF THE EXCHANGE FUND ACCOUNT

1996

(AUSSI DISPONIBLE EN FRANÇAIS)

Exchange Fund Account

Annual Report

December 31, 1996

INTRODUCTION

The Exchange Fund Account is the principal repository of Canada's official international reserves. The Account is governed by the provisions of the Currency Act and is held in the name of the Minister of Finance. The Bank of Canada, acting as fiscal agent under the policy direction of the Minister of Finance, effects transactions for the Account.

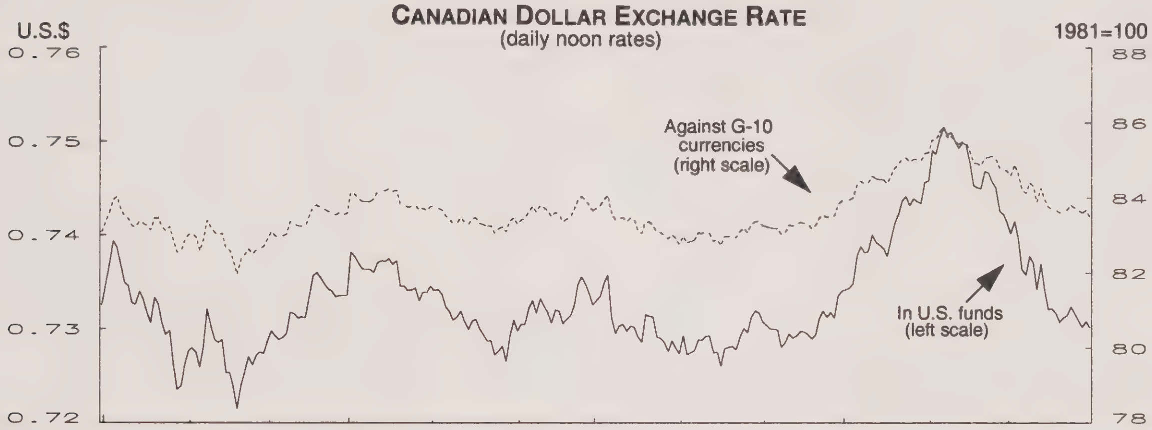
This report reviews the operations of the Exchange Fund Account in 1996 and changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying financial statements of the Exchange Fund Account for 1996 provide additional information on the operations of the Account.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

At the end of 1996, the Canadian dollar remained relatively unchanged from the beginning of the year. It depreciated by 0.4% against the US dollar but appreciated by 0.4% on a trade-weighted basis against G-10 currencies. Over the period, Canada's improved economic fundamentals underpinned the exchange value of the Canadian dollar, allowing declines in interest rates over the year to stimulate the economy consistent with the low trend of inflation.

The year can be roughly divided into two parts, reflecting the substantive changes in the direction of the exchange rate against the US dollar, as shown in the chart below. While trading in a relatively narrow range for much of the first three quarters of the year, the Canadian dollar appreciated sharply in October and November. By the end of December, however, the dollar had fallen back near the year's initial levels.

CANADIAN DOLLAR EXCHANGE RATE
(daily noon rates)



CANADA'S IMPROVED ECONOMIC FUNDAMENTALS

Short-term interest rates began to drop in the fall of 1995 and continued throughout the first half of 1996. Interest rate spreads with the US declined markedly across the yield curve. Despite the narrowing of spreads, the Canadian dollar remained relatively firm in the first half of 1996, trading in a narrow range around a level of US$ .7325. The dip in the dollar in late May and July was caused by concerns over further Bank of Canada easing viewed against possible rate increases by the US Federal Reserve. On a G-10 trade weighted basis, the Canadian dollar remained steady for the first three quarters of the year.

The steady performance of the currency in the face of narrowing spreads with the US reflected the same factors that were supporting the money market - namely Canada's improved economic fundamentals, including, Canada's solid inflation performance, the improved fiscal positions of both the federal and provincial governments and reduced political concerns. The improvement in the current account and Canada's balance of international payments also supported the currency.

PEAKING IN NOVEMBER

The decline in Canadian interest rates moved further out in the maturity spectrum over the summer and fall. By early November, short and medium-term rates had moved below comparable US rates for terms of up to 10 years, and the positive long term differential had narrowed to about 30 basis points. Despite these movements, the Canadian dollar strengthened, although the rise was tempered by concerns over Bank of Canada easing. The dollar's strength was based on favourable economic releases in both Canada and the US and a generally bullish sentiment on the Canadian dollar. Having traded at around the level of US$ .73 during much of the third quarter of the year, it appreciated steadily during October and early November, peaking at US$ .7522.

RETRACEMENT

Through December the dollar weakened, ending the year at US$ .7296. This decline was attributed to profit taking through the period of year-end consolidation and a technical correction to the rise in the previous months.

Adding to the downward pressure, the US dollar weakened, arousing concerns that the Federal Reserve would increase rates. Despite the decline in the Canadian dollar, the underlying bullish sentiment toward the dollar continued as the favourable fundamentals remained intact.

FINANCIAL REVIEW

FOREIGN EXCHANGE MARKET INTERVENTION

An important objective of the Exchange Fund Account is to promote orderly conditions in the foreign exchange market for the Canadian dollar. Acting as agent under the policy direction of the Minister of Finance, the Bank of Canada sells foreign exchange (buys Canadian dollars) when there is downward pressure on the exchange rate, or buys foreign exchange (sells Canadian dollars) when there is upward pressure on the value of the dollar.

Canada's intervention practices vary with the volatility of market conditions. Recent intervention has been more transparent, for larger amounts and less frequent, reflecting both the maturity of the market and larger market flows. As a result of a stable exchange market during much of 1996, the volume of intervention in the year was limited.

Table 1 FOREIGN EXCHANGE MARKET INTERVENTION

	1992	1993	1994	1995	**1996**
			(in millions of U.S. dollars)		
Purchases	4,796	8,038	4,523	5,167	**225**
Sales	-12,950	-11,153	-10,147	-5,509	**-1,241**
Net	-8,154	-3,115	-5,624	-342	**-1,016**

CANADA'S OFFICIAL INTERNATIONAL RESERVES

The Exchange Fund Account is the principal repository of Canada's official international reserves; however the foreign assets of other government entities are also included in the total of reserves.

The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2 CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31

			Of which:			
	1995 Total	**1996 Total**	Exchange Fund Account*	Bank of Canada	Minister of Finance	Receiver General for Canada
			(in millions of U.S. dollars)			
Convertible foreign currencies:						
U.S. dollars	12,127	**17,521**	14,449	3,060	-	12
Other	503	**507**	500	3	-	4
Gold	177	**155**	155	-	-	-
Reserve position in the IMF	1,243	**1,227**	-	-	1,227	-
Special drawing rights	1,177	**1,168**	1,168	-	-	-
Total holdings	15,227	**20,578**	16,272	3,063	1,227	16

* Due to a different accounting treatment for accrued earnings on SDR-denominated assets and year-end revaluation of the investment portfolio, data in this table differs slightly from the corresponding numbers in the attached Financial Statements.

During the year Canada's official reserves increased by US$ 5.4 billion to US$ 20.6 billion at year end. The increase in reserves reflects the decision announced by the Minister of Finance in the 1996 budget to increase the level of official reserves because of the growth and potential volatility of foreign exchange markets. Also, foreign exchange reserves are held for general liquidity purposes and have been increased to be more in line with other countries. The increase in the level of reserves was largely funded in foreign markets, using various short, medium and long-term debt issues. These financing activities are described in greater detail in table 6 below.

The main factors affecting reserves over that period were the following:

Table 3 **SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES**

	1995	**1996**
	(in millions of U.S. dollars)	
Market Intervention	-342	**-1,016**
Other official transactions	281	**-676**
Net borrowings	1,656	**6,052**
Foreign currency earnings	897	**1,021**
Net proceeds of gold sales	157	**114**
Foreign exchange gains (losses)	82	**-117**
Other	21	**-27**
Total	2,752	**5,351**

Other official transactions represent the net acquisition or use of reserves during the year to meet the currency requirements of the government, including foreign debt servicing, payments and contributions to international institutions and foreign expenditures of government departments. The Account's policy is to repurchase foreign currency in the market, over a period of time, to cover these disbursements.

The level of *gold sales* declined during the year. Gold is held in the Account at SDR 35 per ounce (equivalent at year end to US$ 50.33, which approximates its historical cost). Sales at market prices result in net additions to reserves of the U.S. dollar proceeds of sales. More detailed information on monthly levels and changes in Canada's reserves is presented in Table 7.

THE ACCOUNT'S INVESTMENTS AND REVENUES

The Exchange Fund Account earns revenues from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 1996, the Account's income totalled C$ 1,302 million, compared with C$ 1,374 in 1995. Income earned by other reserve holders is added to reserves, but is reported directly by those entities.

The main categories of income earned by the Account are summarized below:

Table 4 **EXCHANGE FUND ACCOUNT INCOME SUMMARY**

	1992	1993	1994	1995	**1996**
		(in millions of Canadian dollars)			
Investment income	1,087	527	371	1,042	**1,247**
Gains on gold sales	1,078	1,561	992	214	**156**
Foreign exchange gains (losses)	1,383	546	542	118	**-101**
Total	3,548	2,634	1,905	1,374	**1,302**

The growth in investment income during the year reflects a higher average level of currency holdings as well as a diversification of investments into longer term investments and other higher yielding assets.

Changes in the *Currency Act* in 1993 provided added flexibility for the investment of reserves. As illustrated in the attached Statement of Revenues and in Note 4 to the financial statements, the Account continues to realize a significant part of its income from investments in U.S. Government securities. However, the term to maturity of these investments has been increased while a larger portion of currency holdings is invested in securities issued by U.S. Federal Agencies, other countries, and international institutions. At year end, the average term to maturity of U.S. dollar investments, including term deposits and securities, was 36 months, with a maximum term to maturity of 9.7 years. The investment portfolio consists predominantly of discount and fixed-rate securities, with floating rate investments representing only a small portion of investments.

Table 5 **TERM STRUCTURE OF U.S. DOLLAR AND OTHER FOREIGN CURRENCY INVESTMENTS AS AT DECEMBER 31, 1996**

Residual term to maturity	Term deposits	U.S. Government** and U.S. Agencies	Japanese Government	Other Sovereign paper	International institutions	Total
	(par values-in millions of U.S. dollars)*					
Under 6 months	2,601	2,539	246	896	196	6,478
6 to 12 months		1,106				1,106
1 to 5 years		7,219			330	7,549
Over 5 years		2,450				2,450
Total	2,601	13,314**	246	896	526	17,583**

* Data in this table reflects the par value of investments. In the attached financial statements, investments are shown at their book value which includes unamortized premiums or discounts where applicable and accrued interest.

** Includes US$ 2,820 million (par value) of U.S. Government securities held temporarily by the Bank of Canada at year end, under short-terms asset swaps. See also note 10(a) to the financial statements that references these swaps.

During the year, a securities lending program was started to enhance the yield on the securities portfolio. At year end, a total of U.S.$ 2.0 billion of U.S. Government securities had been placed with financial institutions that act as agents for on-lending these securities in the market.

The Account also continued to lend gold in the market on a short term basis. At times, the Account entered into forward agreements in order to benefit from upward fluctuations in rates offered on gold loans and to establish rollover rates on these loans prior to their maturity.

The Account sold 327 thousand ounces of gold during the year, resulting in net gains of C$ 156 million. Gold is held in the Account at its approximate historical price (US$ 50.33 per ounce at year end) and sales at market prices against U.S. dollars add to the level of reserves and generate income for the Account. The average price realized on sales in 1996 was US$ 400.41 per ounce, compared to US$ 386.87 in 1995. This compares to average p.m. fixings in London of US$ 387.90 in 1996 and US$ 384.05 in 1995.

The addition to reserves of the proceeds of foreign currency borrowings has resulted in a closer alignment in the relative levels of the Account's foreign currency assets and foreign liabilities. This has resulted in a decline in the impact of exchange rate fluctuations on the Account's income, with residual foreign exchange gains or losses now relating principally to the timing of transactions during the year or to fluctuations in the value of non U.S. dollar-denominated assets.

It has been the Account's policy to hold the equivalent of approximately US$ 0.5 billion in Deutsche marks and Japanese yen. These currencies can be used instead of U.S. dollars when U.S. dollar intervention would counteract the market policies of other countries, or in the context of coordinated G-7 intervention in favor of other currencies. These currencies are held in remunerated cash accounts, term deposits, or in government securities.

Costs Attributable to the Account

The EFA is funded by advances from the CRF. Advances are for the large part denominated in U.S. dollars, with lesser amounts denominated in Canadian dollars and in SDRs. The EFA pays no interest on these advances. The cost of funding official reserves is borne directly by the CRF.

U.S. dollar advances (amounting to US$ 17,366 million at year end) represent the proceeds of the government's foreign financing activities that have been added to official reserves. Subsequent repayments of foreign currency debt result in reductions in advances and in the level of currency holdings of the Account. *SDR advances* (SDR 38 million at year end) represent the allocation to Canada of SDRs issued by the International Monetary Fund, net of SDRs re-used by the Minister to pay for increases in Canada's quota at the IMF. *Canadian dollar advances* from the CRF, or *net deposits* by the EFA with the CRF (net deposits of C$2,848 million at year end) result from net cumulative requirements (advances) or net receipts (deposits) of Canadian dollars by the EFA for the settlement of its purchases or sales of foreign currencies. See also note 9 of the attached financial statements.

At year end the proceeds of the following U.S. dollar borrowings had been advanced to the EFA:

Table 6 **U.S. Dollar Issues Advanced to the EFA**
As at December 31

	1995	**1996**
	(in millions of U.S. dollars)	
Canada Bills	3,028	**5,055**
Canada Notes	-	**1,525**
Swapped domestic issues	286	**1,786**
Bonds	8,000	**9,000**
Total	11,314	**17,366**

To impute the cost of funding the EFA, interest on foreign currency advances can be directly related to foreign currency loans whose proceeds have been advanced to the EFA. These loans have become the main source of financing for the EFA. However, the full cost estimates depend significantly on the assumptions that are made regarding the cost of Canadian dollar borrowings underlying Canadian dollar advances, or the value of Canadian dollar balances for the CRF in the case of deposits with the CRF.

Accounting practices for the cost of advances were reviewed in 1996 and changed to an accrual basis, to allow for a more consistent presentation of cost estimates and revenues for the EFA. In 1996, Canadian dollar advances varied frequently throughout the year, between net deposits and net advances, so that overnight money market rates were used to estimate the daily net value or cost for the EFA of Canadian dollar deposits or advances. The notional imputed cost of funding the EFA in 1996 was C$ 1,336 million. In 1995, this notional cost was estimated to have been between C$ 1,100 and C$ 1,130 million, with the range determined by the source of Canadian dollar financing, i.e. Treasury bills, bonds or average yield on total government debt outstanding. This compares with total income of C$ 1,302 million in 1996 and C$ 1,374 million in 1995, which included investment income of C$ 1,247 million and C$ 1,042 million respectively. See also the Statement of Revenues in the attached financial statements.

Risk Management and Financial Instruments

The role of the Account as principal repository of Canada's official reserves held to moderate movements in the external value of the Canadian dollar and for general liquidity purposes, determines the nature of its assets and of its operations, as well as its use of financial instruments.

The *Currency Act* requires that the Minister designate investments that are eligible as EFA investments, the currencies and units of account in which the assets held by the EFA can be denominated, as well as the issuing governments and institutions that are eligible for EFA investments. These, as well as the criteria used to select eligible investments are published in the *Canada Gazette*. Liquidity and credit risk are key criteria in determining the composition of the EFA's investment portfolio.

While the Account uses selected financial instruments to enhance the yield on its investments or the value of its market transactions, it does not use financial instruments to hedge its asset or liability positions.

Credit Risk

The main criteria for designating institutions, governments, and their agencies whose securities or notes can be purchased or with which deposits can be made, is the credit rating assigned by prominent international credit agencies. Longer term investments require higher credit ratings to provide greater risk protection. Credit risk is also controlled through counterparty limits, and through limits on categories of assets held or of commitments outstanding.

Liquidity Risk

The Account's liquidity management is designed to provide a level of liquid assets sufficient to meet the requirements of foreign exchange market intervention, disbursements related to maturing foreign currency borrowings, or the costs of foreign currency debt servicing and other government departmental currency requirements.

Liquidity management in the Account includes the management of cash balances and short-term investments and, as required, short-term funding. At year end, investments with less than six months to maturity represented 37% of the Account's investment portfolio.

Interest Rate Risk

Interest rate risk arises from differences in the maturity structure of assets and liabilities, or from the need to liquidate investments prior to maturity to meet disbursements. For the EFA's liabilities, the term structure used for risk management is that of the foreign currency borrowings issued by the CRF, whose proceeds have been advanced to the EFA. Risk is minimized by managing the maturity structure of the Account's assets and implicit liabilities; by maintaining a distributed term structure of short term and longer-term investment portfolios; and by monitoring gaps in the term structures or in the relative levels of interest rates on assets and implicit liabilities.

Foreign Exchange Risk

With a close balance between the relative levels of its foreign currency assets and liabilities, the Account's exposure to fluctuations in exchange rates has been limited in recent years. However residual risks arise from the fact that the Account holds assets in several currencies other than the U.S. dollar, and because the Account is subject to buying or selling large amounts of currency to moderate movements in the value of the Canadian dollar.

Gold Loans and Gold Sales

The Account lends most of its gold on a short-term basis to financial institutions and to major gold trading firms. Gold loans are secured by the provision of collateral by borrowers, in the form of letters of credit or promissory notes issued by major financial institutions. The Account has made use

of forward agreements to obtain higher yields on its gold loans. Under such agreements, during periods where loan rates are volatile, interest rates on the renewal of loans is fixed in advance of the renewal date.

The Account sells gold in spot and forward markets. Under forward contracts, the Account is committed to selling gold at future dates for predetermined prices. It also sells call options on a portion of its gold holdings. Under call options contracts, the Account receives a premium against commitments to sell gold at predetermined dates and prices, at the option holders' discretion.

Securities Lending

In 1996, the Account undertook a securities lending program. This involves lending securities through agents to various counterparties. These loans are secured through collateral provided by the counterparties as well as the guarantee of the agents. Income flows from the underlying securities continue to accrue to the Account while they are on loan.

Table 7

CANADA'S OFFICIAL INTERNATIONAL RESERVES[1]
(in millions of U.S. dollars)

Month End	Foreign Currencies: U.S. Dollars	Foreign Currencies: Other[2]	Gold*	Special Drawing Rights*	Reserve Position in the IMF[3]*	Total	Month-to-Month Changes: Total Monthly Changes	of which: Net Borrowings or Repayments in Foreign Currency	Revaluation Effects	Gain on Gold Sales	Official Government Operations[4]
1995											
December	12,127	502	178	1,177	1,243	15,227	166	-25	-1	24	54
1996											
January	11,945	506	170	1,150	1,209	14,980	-247	-63	-78	26	-223
February	11,664	511	171	1,171	1,224	14,741	-239	-279	37	6	-109
March	13,917	509	167	1,165	1,246	17,004	2,263	2,182	-18	16	+25
April	14,291	517	164	1,156	1,235	17,363	359	423	-25	18	-104
May	15,346	502	161	1,156	1,229	18,394	1,031	1,121	-19	14	-184
June	15,677	506	160	1,157	1,231	18,731	337	255	-2	6	7
July	15,586	520	161	1,175	1,249	18,691	-40	299	55	11	-480
August	16.505	508	160	1,176	1,254	19,603	912	909	-20	3	-67
September	16,438	502	156	1,162	1,235	19,493	-110	-101	-46	8	-65
October	16,958	507	156	1,167	1,241	20,029	536	287	8	6	157
November	17,040	501	156	1,176	1,243	20,116	87	-34	-	-	22
December	17,521	507	155	1,168	1,227	20,578	462	1,054	-9	-	-671

1. Daily data for Canada's Official International Reserves and the principal components for the period 1970-95 are available from the Department of Finance on request. Daily data for 1996 will be made available at the time of the release of the Exchange Fund Account report for 1997 and subsequent data will be available with a comparable time lag. Due to a different accounting treatment for accrued earnings on SDR-denominated assets and year-end revaluation of the investment portfolio, the numbers in this table differ slightly from the corresponding numbers in the attached Financial Statements.

2. Valued at closing market rates in terms of U.S. dollars.

3. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

4. Official government operations include purchases and sales of foreign exchange aimed at moderating movements in the Canadian dollar and net government requirements of foreign exchange.

* SDR-denominated assets are valued at the U.S. dollar rate for the SDR established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.

Exchange Fund Account

Financial Statements

December 31, 1996

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the Currency Act. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies of the Government of Canada set out in Note 2 to the financial statements. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for Exchange Fund Account transactions and investments, and related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the Currency Act.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of his audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are part of the Public Accounts, and are referred to the Standing Committee on Public Accounts for their review.

Governor
Bank of Canada

Deputy Minister
Department of Finance

Ron Parker

Chief, Financial Markets Department
Bank of Canada

AUDITOR GENERAL OF CANADA VÉRIFICATEUR GÉNÉRAL DU CANADA

AUDITOR'S REPORT

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 1996 and the statement of revenues due to the Consolidated Revenue Fund for the year then ended. These financial statements are the responsibility of the Department of Finance. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by the Department of Finance, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 1996 and the revenues due to the Consolidated Revenue Fund for the year then ended in accordance with the stated accounting policies of the Government of Canada set out in Note 2 to the financial statements.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with the applicable provisions of Part II of the Currency Act.

John Wiersema, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
February 21, 1997

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 1996

	1996		1995	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
ASSETS				
Denominated in U.S. dollars				
Cash and short-term deposits	**$ 2,431**	**$ 3,332**	$ 2,350	$ 3,206
Marketable securities (Note 4)	**12,007**	**16,457**	5,724	7,807
	14,438	**19,789**	8,074	11,013
Denominated in other foreign currencies				
Cash and short-term deposits (Note 5)	**256**	**351**	255	348
Marketable securities (Note 6)	**244**	**335**	240	327
	500	**686**	495	675
Denominated in special drawing rights				
Special drawing rights (Note 7)	**1,176**	**1,612**	1,185	1,617
Gold and gold loans (Note 8)	**157**	**215**	180	245
	1,333	**1,827**	1,365	1,862
Official international reserve assets	**$ 16,271**	**22,302**	$ 9,934	13,550
Denominated in Canadian dollars				
Cash		**-**		1
Other (Note 10a)		**30**		(9)
		$ 22,332		$ 13,542

DUE TO THE CONSOLIDATED REVENUE FUND

Advances (Note 9)	**$ 21,030**	$ 12,168
Revenues for the year	**1,302**	1,374
	$ 22,332	$ 13,542

Commitments (Notes 10(b), (c))

Approved:

Governor
Bank of Canada

Deputy Minister
Department of Finance

Chief, Financial Markets Department
Bank of Canada

See accompanying notes

EXCHANGE FUND ACCOUNT

Statement of Revenues Due to the Consolidated Revenue Fund

For the year ended December 31, 1996

	1996	1995
	(in millions of Canadian dollars)	
Investment income		
Marketable securities	**$ 961**	$ 758
Cash and short-term deposits	**197**	188
Special drawing rights	**63**	79
Gold	**26**	17
	1,247	1,042
Other income		
Gain on sales of gold	**156**	214
Net foreign exchange gains (losses) (Notes 10(a),11)	**(101)**	118
	55	332
Revenues for the year due to the Consolidated Revenue Fund (Note 2(e))	**$ 1,302**	$ 1,374

See accompanying notes

EXCHANGE FUND ACCOUNT

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1996

1. AUTHORITY AND OBJECTIVE

The Exchange Fund Account (the Account) is governed by Part II of the Currency Act (the Act). The Account is in the name of the Minister of Finance (the Minister) and is administered by the Bank of Canada as fiscal agent. The Financial Administration Act does not apply to the Account.

The main objective of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister acquires or sells for the Account those assets which are deemed appropriate for this purpose in accordance with the Act. The Act requires that the Minister publish in the Canada Gazette the list of currencies and units of account deemed eligible as assets of the Exchange Fund Account, as well as the investment criteria used for the designation of eligible issuers and securities.

2. SIGNIFICANT ACCOUNTING POLICIES

Significant account policies of the Account are set out below. As required by the Currency Act, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements.

a) Valuation of assets

The estimated fair market value of cash and short-term deposits, which are generally held to maturity, is equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts where applicable, and are reported at the lower of their amortized cost or year-end market value.

Marketable securities, short-term deposits and special drawing rights (SDRs) include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of five major currencies.

Gold and gold loans includes accrued interest. Gold is carried in the Account at a value of 35 SDRs per fine ounce, which conforms to the value used in the Public Accounts of Canada.

b) Investment income

Investment income is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts. Write downs of securities to their year-end market value and gains and losses on the sale of marketable securities are recorded as a charge or a credit to investment income in the year in which they occur. Purchases and sales of securities are recorded at the settlement date.

c) *Gold*

Gold sales and net gains on gold sales are recorded at settlement date. Interest revenue from gold loans is recorded on an accrual basis and is included in investment income.

d) *Translation of foreign currencies and SDRs*

Assets and advances denominated in foreign currencies and SDRs are translated into Canadian and U.S. dollar equivalents at year-end market exchange rates, which were as follows:

	Canadian dollars	
	1996	1995
U.S. dollar	**1.3706**	1.3640
Japanese yen	**.01182**	.01319
Deutsche mark	**.8907**	.9496
Special drawing right	**1.97087**	2.02757

Net foreign exchange gains or losses result from the translation of foreign currency balances and transactions throughout the year. Unrealized foreign currency translation gains or losses on short-term currency swaps arrangements with the Bank of Canada are recorded in other assets and in net foreign exchange gains or losses. See also Note 10(a).

Investment income in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the income is earned.

e) *Disposition of revenues*

The revenues for the year are payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the Act.

f) *Services received without charge*

The Account receives, without charge, administrative, custodial and fiscal agency services from the Bank of Canada.

g) *Interest-free advances*

The Account receives interest-free advances from the Consolidated Revenue Fund.

3. OFFICIAL GOVERNMENT OPERATIONS

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to moderate movements in the value of the Canadian dollar, or to meet net government requirements of foreign exchange. During the year, US$ 1,692 million (net) in official international reserves were used for these operations (1995: net use of US$ 61 million). Transactions aimed at moderating movements in the value of the Canadian dollar comprised sales of foreign currency of US$ 1,241 million (1995: US$ 5,509 million) and purchases of foreign currency of US$ 225 million (1995: US$ 5,167 million).

4. Marketable Securities Denominated in U.S. Dollars

	1996		1995	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
U.S. Government securities	**$ 8,978**	**$ 12,305**	$ 3,532	$ 4,818
U.S. Federal Agencies securities	**1,519**	**2,082**	1,143	1,560
Sovereign paper	**885**	**1,213**	594	809
International Institutions securities	**515**	**706**	393	536
Accrued interest	**119**	**163**	62	84
Amortized cost at year end:	**$ 12,016**	**$ 16,469**	$ 5,724	$ 7,807
Estimated market value at year end:	**$ 12,007**	**$ 16,457**	$ 5,815	$ 7,932

At year end, the value of securities was written down by US $9 million (C$ 12 million) from their amortized cost, to reflect the estimated net market value of these assets. A charge of C$ 12 million was made against the current year's investment income.

5. Cash and Short-Term Deposits Denominated in Other Foreign Currencies

	1996		1995	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Japanese yen	**$ 1**	**$ 1**	$ 1	$ 2
Deutsche marks	**254**	**348**	253	344
Accrued interest	**1**	**2**	1	2
	$ 256	**$ 351**	$ 255	$ 348

6. Marketable Securities Denominated in Other Foreign Currencies

	1996		1995	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Japanese Government securities				
Amortized cost at year end:	**$ 244**	**$ 335**	$ 240	$ 327
Estimated market value at year end:	**$ 246**	**$ 338**	$ 242	$ 330

7. Special Drawing Rights

	1996	1995
	(in millions of SDRs)	
Held at the end of the year	**812**	792
Accrued interest	**5**	6
	817	798

	1996		1995	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
Held at the end of the year	**$ 1,168**	**$ 1,601**	$ 1,177	$ 1,606
Accrued interest	**8**	**11**	8	11
	$ 1,176	**$ 1,612**	$ 1,185	$ 1,617

8. Gold and Gold Loans

	1996	1995
	(in thousands of fine ounces)	
Held at the beginning of the year		
Gold	**122**	999
Gold loans	**3,292**	2,886
	3,414	3,885
Sold during the year	**327**	471
Held at the end of the year	**3,087**	3,414
Composed of		
Gold	**109**	122
Gold loans	**2,978**	3,292
	3,087	3,414

	1996		1995	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
Held at the end of the year				
Gold	**$ 5**	**$ 8**	$ 7	$ 9
Gold loans	**150**	**205**	171	233
Accrued interest on gold loans	**2**	**2**	2	3
	$ 157	**$ 215**	$ 180	$ 245

The recorded value, the market value (based on London fixings), and the approximate Canadian dollar cost at historical rates of exchange of gold and gold loans excluding accrued interest, at year end are:

		1996		1995	
		Price per fine ounce	***Total value in millions***	Price per fine ounce	Total value in millions
Recorded value	- US$	**$ 50.33**	**$ 155**	$ 52.03	$ 178
	- C$	**68.98**	**213**	70.96	242
Market value	- US$	**369.55**	**1,141**	386.70	1,320
	- C$	**506.51**	**1,564**	527.46	1,801
Approximate historical cost	- C$	**36.91**	**114**	36.91	126

9. Due to the Consolidated Revenue Fund - Advances

The Account is funded by advances from the CRF. During the year, these were limited to C$25 billion by Order in Council dated June 30, 1988 (revised by Order in Council to C$ 35 billion effective February 21, 1997). At year end, advances from (to) the CRF consisted of:

	1996	1995
	(in millions of Canadian dollars)	
U.S. dollars	**$ 23,802**	$ 15,432
Canadian dollars	**(2,848)**	(3,342)
Special drawing rights	**76**	78
	$ 21,030	$ 12,168

The proceeds of Canada's borrowings in foreign currency and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Repayments of foreign currency debt are made using the assets of the Account. Interest payable by Canada on borrowings in foreign currencies and charges on SDR allocations to Canada are charged directly to the CRF.

10. Commitments

a) Currency swaps

The Account enters into short-term currency swap arrangements with the Bank of Canada. The objective of these swaps is to assist the Bank in its cash management operations. Under these agreements, the Account sells U.S. dollars for Canadian dollars, with simultaneous agreements to repurchase U.S. dollars on future dates at the same exchange rates in effect at the time the swaps were entered into. These swaps result in temporary decreases in the Account's foreign currency assets and in the level of advances from the CRF. The effect is reversed when the swaps mature.

At year end, the Account had the following commitments to repurchase U.S. dollars under swap arrangements with the Bank of Canada:

	1996		1995	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Value at cost:	**$ 2,944**	**$ 4,005**	$ 3,927	$ 5,365
Value at market:	**$ 2,944**	**$ 4,035**	$ 3,927	$ 5,356

Unrealized exchange gains of C$ 30 million (1995: loss of C$ 9 million) related to currency swap arrangements outstanding at year end with the Bank of Canada are included in *Other assets* and *Net foreign exchange gains (losses).*

b) Uncompleted transactions

At year end, the Account had commitments for net purchases of US$ 10 million and 520 million Japanese yen, and sales of 5 million deutsche marks and C$ 15 million (1995: net purchases of US$ 8 million against C$ 11 million), all maturing in January 1997.

c) Gold options

The Minister has authorized the sale of call options on part of the Account's gold holdings. Under such transactions, the Account receives a premium against commitments to sell gold, at predetermined prices, on the expiry date of the options which can be exercised at the holder's discretion. No gold is sold unless the holders of the options exercise their right on the expiry dates.

At year end, the Account had outstanding commitments to sell 70,000 fine ounces of gold under call option contracts with a total value of US$ 27 million (1995: 90,000 fine ounces with a total value of US$ 36 million) all maturing by March 1997.

11. NET FOREIGN EXCHANGE GAINS (LOSSES)

	1996			1995
	Assets	***Liabilities***	***Net***	Net
	(in millions of Canadian dollars)			
Assets and liabilities denominated in:				
U.S. dollars	**$ 96**	**$ (119)**	**$ (23)**	$ 124
Japanese yen	**(37)**	**-**	**(37)**	(11)
Deutsche marks	**(22)**	**-**	**(22)**	25
Special drawing rights	**(51)**	**2**	**(49)**	(11)
	$ (14)	**$ (117)**	**(131)**	127
Unrealized gains			**30**	(9)
Net foreign exchange gains (losses) for the year			**$ (101)**	$ 118

ANNUAL REPORT TO PARLIAMENT ON THE OPERATIONS OF THE EXCHANGE FUND ACCOUNT BY THE MINISTER OF FINANCE

AND

REPORT OF THE AUDITOR GENERAL TO THE MINISTER OF FINANCE ON THE EXAMINATION OF THE ACCOUNTS AND FINANCIAL STATEMENTS OF THE EXCHANGE FUND ACCOUNT

1998

(AUSSI DISPONIBLE EN FRANÇAIS)

Introduction

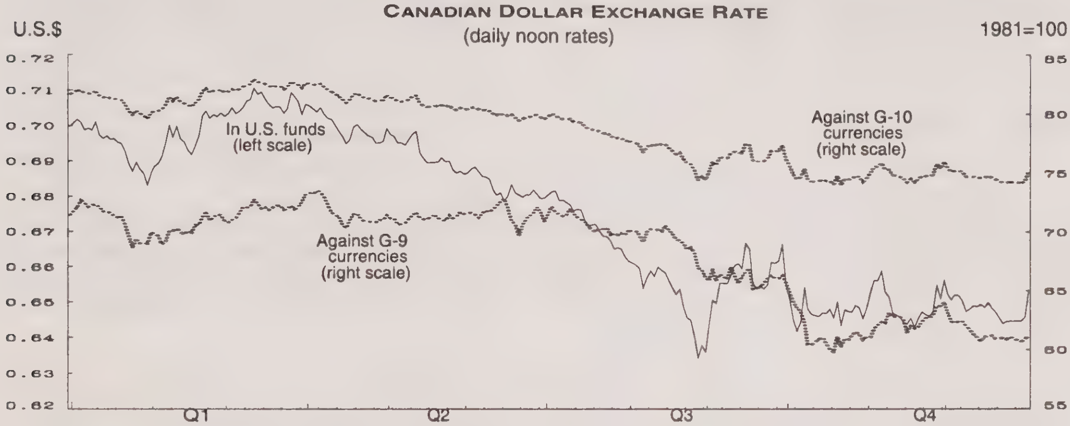
The Exchange Fund Account ("EFA") is the principal repository of Canada's official international reserves. The EFA is governed by the provisions of the *Currency Act* and is held in the name of the Minister of Finance. The Bank of Canada, acting as fiscal agent under the policy direction of the Minister of Finance, effects transactions for the EFA.

This report reviews the operations of the Exchange Fund Account in 1998 from January 1, 1998 to December 31, 1998 and changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying Financial Statements of the Exchange Fund Account for 1998 provide additional information on the operations of the EFA.

Foreign Exchange Market Developments

The Canadian dollar fell by more than four and a half U.S. cents (or 7%) against the U.S. dollar over the year, closing at US$ 0.6522. The high for the Canadian currency for the year was, US$ 0.7123, occurring on March 13. The low was recorded on August 27 at US$ 0.6311, the all-time weakest level for the Canadian dollar against its U.S. counterpart. The Canadian dollar depreciated by 8% on a trade-weighted basis against G-10 currencies, slightly more than it fell against the U.S. currency alone, given that the U.S. dollar was weaker against other major (G-9) currencies over the period. (With the advent of the Euro on January 1, 1999, a C-6 trade-weighted index will replace the G-10 index. Similarly, a C-5 index will replace the G-9 index which excludes the U.S. dollar.)

Canadian Dollar Exchange Rate
(daily noon rates)



International Financial Developments during 1998

International economic developments during the year were influenced by an environment of high uncertainty and financial market volatility. North America continued to grow, fuelled by the very strong expansion in the U.S. The recovery in continental Europe accelerated early in the year, although the pace moderated after the summer. In contrast, the countries directly affected by the "Asian crisis" suffered deep recessions. Japan continued to experience its deepest contraction in the last 50 years.

Foreign exchange market trends over the past year can be divided into three periods: the first half of the year, characterized by high uncertainty over the fallout of the Asian crisis; then, just as these concerns progressively eased, a period of renewed high volatility in August, resulting from events in Russia; and finally, towards the end of the year, a further period of heightened uncertainty emerged, amid "credit crunch" fears in the U.S., leading to official interest rate declines in the U.S. and across other major industrial countries.

Continued Concerns over Asian Contagion

Early in the year, financial markets were heavily influenced by the continuing crisis in Asia. Heightened economic uncertainty and financial volatility affected economies that were perceived as vulnerable to Asian contagion.

In Japan, the situation deteriorated more than expected as the crisis in neighbouring Asian countries compounded Japan's domestic economic problems. Reflecting these developments, the yen depreciated significantly. Authorities acted to reverse this trend in June as some feared further yen weakness threatened the recovery in Asia and the stability of the Chinese currency and the Hong Kong peg. Even as the year ended, prospects for recovery in Japan were dim and the continuing recession was seen as an important source of uncertainty for the world economy.

Over the first half of 1998, the Canadian dollar oscillated in a 3 1/2 US cent range in the midst of this global uncertainly, but adopted a decidedly weaker bias throughout the second quarter. The currency traded from a high of US$ 0.7123 in mid-March to a US$ 0.6777 low in mid-June.

VOLATILITY IN THE AFTERMATH OF THE RUSSIAN MORATORIUM

Compounding the situation in Asia, emerging economies in other parts of the world also experienced mounting difficulties. In mid-August, the Russian government declared a unilateral moratorium on some of its debt payments, precipitating a new episode of financial turbulence.

This so-called "Russian crisis" led to a worldwide capital flight to more secure assets, mostly U.S. Treasuries and core European bonds. Fears of further contagion affected other emerging economies, particularly in Latin America. Economies in Latin America were particularly affected as they had to pay high risk premiums to access international financial markets.

This period was also characterized by strong market pressure on the so-called "commodity-related currencies", including the Canadian dollar. The currency declined sharply to a new historical low of US$ 0.6311 on August 27, before a 1 percentage point increase in the Bank Rate helped to reverse the trend.

TIGHTER CREDIT CONDITIONS

The financial flows into U.S. Treasuries resulted in a significant widening of the interest rate spreads on corporate debt relative to U.S. government debt as investors' main concern turned to safety. Reduced liquidity in financial markets and tighter credit conditions led some to raise concerns about a possible credit crunch. Between late-September and mid-November, the Federal Reserve lowered its target rate for federal funds by 25 basis points on three occasions, to 4 3/4 per cent. In the wake of these interest rate reductions, the rise in interest rate spreads on corporate debt began to reverse and U.S. equity markets rebounded strongly.

The Bank of Canada matched the three interest rate reductions by the Federal Reserve, allowing it to unwind most of the August increase, and the Canadian dollar traded in a narrow range, between US$ 0.6671 and US$ 0.6404, for the remaining four months of the year.

FINANCIAL REVIEW

1. FOREIGN EXCHANGE MARKET INTERVENTION

The objectives of the Exchange Fund Account ("EFA") are to promote orderly conditions in the foreign exchange market for the Canadian dollar and provide general liquidity for the government. During the period from January to September 1998 the Bank of Canada, acting as agent for the Department of Finance, purchased US$ 51 million and sold US$ 9,063 million U.S. dollars for intervention purposes. Intervention was heaviest during August, 1998 as the Canadian dollar reached its all time lowest level (see Table 7).

In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling foreign exchange / buying Canadian dollars when there is downward pressure on the exchange rate, or buying foreign exchange / selling Canadian dollars when there is upward pressure on the value of the dollar). Instead, the Bank of Canada will now intervene in a less automatic manner that allows more discretion in the timing and amount of intervention in order to maximize flexibility and increase the signalling effect to the market of its intervention activities.

Canada's intervention practices have varied with changes in market conditions. In recent years, intervention has generally been less frequent, reflecting the maturity of the market. However, when required, intervention was often for larger amounts, reflecting larger market flows and occasionally the greater volatility of the exchange rate.

Table 1 FOREIGN EXCHANGE MARKET INTERVENTION

	1994	1995	1996	1997	**1998**
			(in millions of U.S. dollars)		
Purchases	4,523	5,167	225	1,665	**51**
Sales	-10,147	-5,509	-1,241	-5,326	**-9,063**
Net	-5,624	-342	-1,016	-3,661	**-9,012**

2. Canada's Official International Reserves

The Exchange Fund Account is the principal repository of Canada's official international reserves; however the foreign assets of other government entities are also included in the total of reserves. The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2 **CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31**

	1997 Total	**1998 Total**	Of which: Exchange Fund Account*	Bank of Canada	Minister of Finance	Receiver General for Canada
			(in millions of U.S. dollars)			
Convertible foreign currencies:						
U.S. dollars	14,630	**15,907**	12,865	3,042	-	-
Other	492	**4,004**	3,997	3	-	4
Gold	146	**122**	122	-	-	-
Reserve position in the IMF	1,575	**2,297**	288	-	2,009	-
Special drawing rights	1,126	**1,097**	1,097	-	-	-
Total holdings	17,969	**23,427**	18,369	3,045	2,009	4

* Due to a different accounting treatment at year end for holdings of other currencies, accrued earnings on SDR-denominated assets, the year-end revaluation of the investment portfolio and unrealized gains / losses on foreign currency hedges, some data may differ from the corresponding numbers in the attached Financial Statements.

During the year Canada's official reserves increased by US$ 5.5 billion to US$ 23.4 billion at year end. The increase in the level of reserves over this period was largely funded in foreign markets, using various short, medium and long-term debt issues as well as swapped domestic issues. These financing activities are described in greater detail in Table 6. As indicated by the Minister of Finance in the 1996 and 1998 budgets, Canada has moved to increase its level of foreign exchange reserves. This reflects the increased flows and volatility of foreign exchange markets, and will bring Canada's reserves more in line with other comparable countries.

Table 3 below outlines the main factors affecting the level of reserves:

Table 3 **SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES**

	1997	**1998**
	(in millions of U.S. dollars)	
Market Intervention	-3,661	**-9,012**
Other official transactions	-1,187	**-1,457**
Net borrowings including cross-currency swaps	1,396	**14,138**
Foreign currency earnings	1,083	**1,228**
Net proceeds of gold sales	-	**168**
Foreign exchange gains (losses) on non US dollar foreign currencies	-192	**400**
Other	-48	**-7**
Total	-2,609	**5,458**

Other official transactions represent the net use of reserves during the year to meet the currency requirements of the government, including foreign debt servicing, payments and contributions to international institutions and foreign expenditures of government departments. The EFA's policy is to repurchase foreign currency in the market, over a period of time, to cover these disbursements.

Gold is held in the EFA at SDR 35 per ounce (equivalent at year end to US$ 49.24) which approximates its historical cost. Sales of gold at market prices result in the net addition to reserves of the U.S. dollar proceeds of sales. The EFA sold gold on a forward basis during the year, for delivery and settlement in both 1998 and 1999. A total of 600,000 ounces were delivered and settled in 1998 (including 444,000 ounces which had been originally sold forward in 1997, and 50,000 ounces which were sold as a result of options being exercised during 1998). At year end, the EFA had commitments for sales of 270,000 fine ounces of gold in 1999 for a total value of US$ 82.4 million.

More detailed information on monthly levels and changes in Canada's reserves is presented in Table 7.

3. The Exchange Fund Account's Investments

The *Currency Act* requires that the Minister designate the types of financial instruments that are eligible as EFA investments, the currencies and units of account in which the assets held by the EFA can be denominated, as well as the issuing governments and institutions that are eligible for EFA investments. These, as well as the criteria used to select eligible investments are published in the *Canada Gazette*. The Bank of Canada acts as agent in managing the assets of the Exchange Fund Account, pursuant to these criteria and to guidelines approved by the Minister.

The primary objective in managing EFA investments is to ensure a sufficient amount of high-quality, highly liquid assets to meet prospective needs for intervention in the foreign exchange market and for general liquidity purposes. The secondary objective is to minimize the net carrying cost of the government's foreign currency liabilities that are used to fund the EFA.

The EFA's investments are distributed between two distinct tiers as follows:

a) A liquidity tier of readily marketable, high quality assets with maturities of six months or less, to provide for intervention requirements and other liquidity needs. Short-term and floating-rate assets are matched to the extent possible to foreign currency liabilities to immunize interest rate risk.

b) An investment tier of assets with terms to maturity up to 10.5 years is managed to the extent possible on the basis of currency and interest rate risk immunization and carrying cost minimization.

It has been the EFA's policy to hold the equivalent of approximately US$ 500 million in German marks and Japanese yen, in addition to U.S. dollars, in the liquidity tie for coordinated G-7 intervention purposes. These currencies are held in remunerated cash accounts, and in short-term deposits and short-term government securities. Going forward from January 1, 1999, the need to maintain separate euro and Japanese yen assets in the liquidity tier may become unnecessary as significant liquid euro and yen assets have been or are being added to the investment tier to match longer-term euro and yen denominated liabilities.

Table 4 **TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS AND LIABILITIES AS AT DECEMBER 31, 1998**

(par values* in millions of U.S. dollars)

Duration	Foreign currency investments: Cash and term deposits	Government securities**	Other securities	Total assets	Foreign currency liabilities
LIQUIDITY TIER					
Under 6 months					
US dollars	3,525	2,117	26	5,668	8,623
German marks	124	122	-	246	-
Japanese yen	-	277	-	277	-
US DOLLAR LIABILITY MATCHING TIER					
Under 6 months	-	-	-	-	-
6 to 12 months	-	-	30	30	445
1 to 5 years	-	3,858	470	4,328	10,226
Over 5 years	-	4,856	485	5,341	10,675
GERMAN MARK LIABILITY MATCHING TIER					
Under 6 months	126	-	-	126	-
Over 5 years	-	2,419	-	2,419	2,397
FRENCH FRANC LIABILITY MATCHING TIER					
Over 5 years	-	706	-	706	715
TOTAL	**3,775**	**14,355**	**1,011**	**19,141**	**33,081**

* Data in this table reflect the par value of investments. In the attached Financial Statements, investments are reported at their book value which includes unamortized premiums or discounts where applicable and accrued interest.

** Includes US$ 2,800 million (par value) of U.S. Government securities held temporarily by the Bank of Canada at year end, under short-terms asset swaps. See also note 9(a) to the Financial Statements that references these swaps.

4. THE EXCHANGE FUND ACCOUNT'S REVENUES

The Exchange Fund Account's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 1998, the EFA's income totalled C$ 1,656 million, compared with C$ 1,336 million in 1997. Income earned by other reserve holders is added to official reserves, but is reported directly by those other entities.

The main categories of income earned by the EFA are summarized below:

Table 5 **EXCHANGE FUND ACCOUNT INCOME SUMMARY**

	1994	1995	1996	1997	**1998**
		(in millions of Canadian dollars)			
INVESTMENT INCOME					
Marketable securities	168	758	961	1,030	**1,364**
Cash and short-term deposits	131	188	197	260	**257**
Special drawing rights	67	79	63	64	**69**
Gold	5	17	26	23	**26**
Total investment income	371	1,042	1,247	1,377	**1,716**
OTHER INCOME					
Gains on gold sales	992	214	156	-	**253**
Foreign exchange gains (losses)	542	127	(101)	(41)	**(313)**
TOTAL INCOME	1,905	1,383	1,302	1,336	**1,656**

At year end, the EFA's portfolio of marketable securities consisted entirely of discount and fixed-rate securities; there were no floating rate investments held.

The EFA's securities lending program enhances the yield on the securities portfolio. At year end, a total of US$ 2,775 million of U.S. Government securities were held by financial institutions that act as agents for on-lending these securities in the market. This is unchanged from the US$ 2,775 million total at the end of 1997.

The EFA continued to lend gold in the market on a short term basis, periodically using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans and to establish rollover rates on these loans prior to their maturity. It also continued sales of call options on part of the gold holdings. Income from these activities is reported as investment income on gold.

5. COSTS ATTRIBUTABLE TO THE EXCHANGE FUND ACCOUNT

The EFA is funded by advances from the Consolidated Revenue Fund ("CRF"). Advances are primarily denominated in U.S. dollars, with lesser amounts denominated in Canadian dollars and in SDRs. The EFA pays no interest on these advances. The cost of funding official reserves is borne directly by the CRF.

To impute a notional cost of funding the EFA, interest on foreign currency advances can be directly related to foreign currency borrowings whose proceeds have been advanced to the EFA. These borrowings have become the main source of financing for the EFA. However, the full cost estimates depend significantly on the assumptions that are made regarding the cost of Canadian dollar borrowings underlying Canadian dollar advances, or the value of Canadian dollar balances for the CRF in the case of EFA deposits with the CRF.

U.S. dollar and other foreign currency advances (amounting to US$ 33,081 million at year end) represent the proceeds of the government's foreign financing activities that have been added to official reserves. Subsequent repayments of foreign currency debt result in reductions in advances and in the level of currency holdings of the EFA. *SDR advances* (SDR 38 million at year end) represent the allocation to Canada of SDRs issued by the International Monetary Fund, net of SDRs re-used by the Minister to pay for increases in Canada's quota at the IMF. *Canadian dollar advances* from the CRF, or *net deposits* by the EFA with the CRF (net deposits of C$ 24,340 million at year end) result from net cumulative requirements (advances) or net cumulative receipts (deposits) of Canadian dollars by the EFA for the settlement of its purchases or sales of foreign currencies. See also note 8 of the attached Financial Statements.

As of year-end, the net proceeds of the following U.S. dollar borrowings had been advanced to the EFA:

Table 6 **FOREIGN CURRENCY ISSUES ADVANCED TO THE EFA AS AT DECEMBER 31**

	1997	**1998**
	(in millions of U.S. dollars)	
Bonds	6,319	**13,217**
Canada Bills	5,580	**6,622**
Swapped domestic issues	3,036	**8,341**
Floating Rate Note	2,000	**2,000**
Canada Notes	1,277	**416**
Euro Medium Term Notes	550	**2,485**
TOTAL	18,762	**33,081**

In 1998, the EFA deposits with the CRF varied between C$ 6,500 million and C$ 24,500 million. In light of the EFA's persistent deposit position with the CRF, 3-month Government of Canada treasury bill rates were used to estimate the net value of these deposits.

The overall imputed notional cost of funding the EFA in 1998 was estimated between C$ 1,800 million and C$ 1,850 million. In 1997, this notional cost was estimated to have been C$ 1,416 million.

6. RISK MANAGEMENT AND FINANCIAL INSTRUMENTS

The role of the EFA as principal repository of Canada's official reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

During the year, the EFA used selected financial instruments to enhance the yield on its investments or the value of its market transactions, and to hedge a portion of its currency holdings against foreign exchange risks.

Credit Risk

The main criteria for designating institutions, governments, and their agencies whose securities or notes can be purchased or with which deposits can be made, is the credit rating assigned by prominent international credit agencies. Longer term investments require higher credit ratings to provide greater risk protection. Credit risk is also controlled through counterparty limits, and through limits on categories of assets held or of commitments outstanding.

Liquidity Risk

The EFA's liquidity management is designed to provide a level of liquid assets sufficient to meet the requirements of foreign exchange market intervention, disbursements related to maturing foreign currency borrowings, or the costs of foreign currency debt servicing and other government departmental currency requirements. Liquidity risk management is especially important for the EFA given that intervention requirements are inherently unpredictable. Liquidity management in the EFA therefore includes the management of cash balances and short-term investments. At year end, assets with less than six months to maturity represented 33% of the EFA's portfolio.

Liability management is also an important element of liquidity management given that the EFA is largely funded by foreign currency borrowings, including a US dollar commercial paper program (see "Canada Bills" in Table 6). The government manages foreign currency borrowings so as to typically keep total liabilities on foreign currency borrowings coming due within one year to an amount that is less than one-third of total liquid foreign currency assets. At year-end, total liabilities coming due within one year were US$ 9,068 million.

Interest Rate Risk

Interest rate risk arises from differences in the duration of assets and liabilities, or from the need to liquidate investments prior to maturity to meet disbursements. Risk is minimized by managing the duration structure of the EFA's assets and implicit liabilities; by maintaining portfolios of short-term and longer-term investments; and by monitoring gaps in the duration structures or in the relative levels of interest rates on assets and implicit liabilities. Liabilities used as reference for risk management are the foreign currency borrowings of the CRF, the proceeds of which have been advanced to the EFA.

Foreign Exchange Risk

Due to the nature of the EFA's holdings, fluctuations in the value of the U.S. dollar vis-à-vis the Canadian dollar are reflected in income for the year. To a large extent, however, EFA assets are funded by liabilities denominated in the same currency so as to minimize foreign exchange risk. Such an asset/liability matching framework eliminates much of the foreign exchange exposure on German mark and French franc assets (and similarly euro assets once redenomination takes place after January 1,1999).

Residual risks still arise from the fact that the EFA holds assets in several currencies other than the U.S. dollar which are not offset by a corresponding liability, and because the EFA is subject to the potential for buying or selling large amounts of currency for intervention purposes. During the year the EFA entered into forward foreign exchange hedge contracts to reduce its exposure to changes in the U.S. dollar value of its holdings of Japanese yen and German marks which were not offset by a corresponding liability.

Gold Loans and Gold Sales

The EFA lends most of its gold on a short-term basis to financial institutions and to major gold trading firms. Gold loans are secured by the provision of collateral by borrowers, in the form of letters of credit or promissory notes issued by major financial institutions. The EFA has made use of forward agreements to obtain higher yields on its gold loans. Under such agreements, during periods where loan rates are volatile, interest rates on the renewal of loans are fixed in advance of the renewal date.

The EFA sells gold in spot and forward markets. Under forward contracts, the EFA is committed to selling gold at future dates for predetermined prices. It also sells call options on a portion of its gold holdings. Under call options contracts, the EFA receives a premium against commitments to sell gold at predetermined dates and prices, at the option holders' discretion.

Securities Lending

The EFA's securities lending program involves lending securities through agents to various counterparties. These loans are secured through collateral provided by the counterparties, as well as the guarantee of the agent. Income flows from the underlying securities continue to accrue to the EFA while they are on loan.

Table 7

CANADA'S OFFICIAL INTERNATIONAL RESERVES[1]
(in millions of U.S. dollars)

	Foreign Currencies						Month-to-Month Changes	of which:			
Month End	U.S. Dollars	Other[2]	Gold[3]	Special Drawing Rights[3]	Reserve Position in the IMF[3,4]	Total	Total Monthly Changes	Net Borrowings or Repayments in Foreign Currency	Revaluation Effects	Gain on Gold Sales	Official Government Operations[5]
1997											
December	14,630	492	146	1,126	1,575	17,969	-805	1,103	-30	-	-1,942
1998											
January	14,662	501	145	1,122	1,571	18,001	32	1,551	8		-1,610
February	17,948	503	146	1,137	1,576	21,310	3,309	3,009	17	-	197
March	19,099	495	144	1,124	1,560	22,422	1,112	1,160	-44	-	-99
April	18,515	505	145	1,049	1,572	21,786	-636	-433	35	-	-340
May	17,242	493	144	1,053	1,632	20,564	-1,222	-767	-30	-	-528
June	16,677	490	144	1,038	1,625	19,974	-590	124	-5	-	-801
July	16,545	2,907	136	1,036	1,896	22,520	2,546	2,786	27	47	-406
August	11,903	2,969	131	1,047	1,915	17,965	-4,555	1,022	79	38	-5,824
September	13,251	3,143	123	1,070	1,956	19,543	1,578	1,824	238	62	-644
October	13,609	3,279	123	1,099	2,005	20,115	572	458	111	19	-140
November	16,185	3,899	120	1,076	2,062	23,342	3,227	3,483	-157	2	-187
December	15,907	4,004	122	1,097	2,297	23,427	85	-79	121	-	-85

1. Due to a different accounting treatment for accrued earnings on SDR-denominated assets and year-end revaluation of holdings of other currencies and the investment portfolio, the numbers in this table differ slightly from the corresponding numbers in the attached Financial Statements.
2. Valued at closing market rates in terms of U.S. dollars.
3. SDR-denominated assets are valued at the U.S. dollar rate for the SDR established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
4. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.
5. Official government operations include purchases and sales of foreign exchange aimed at moderating movements in the Canadian dollar and net government requirements of foreign exchange.

EXCHANGE FUND ACCOUNT

FINANCIAL STATEMENTS

DECEMBER 31, 1998

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies of the Government of Canada set out in Note 2 to the financial statements. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of his audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are part of the Public Account and are referred to the Standing Committee on Public Accounts for their review.

Governor
Bank of Canada

C. Scott Clark
Deputy Minister
Department of Finance

B. J. Mahoney
Chief Accountant
Bank of Canada

AUDITOR GENERAL OF CANADA

VÉRIFICATEUR GÉNÉRAL DU CANADA

AUDITOR'S REPORT

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 1998 and the statement of revenues for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by the Account's management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 1998 and its revenues and its cash flows for the year then ended in accordance with the accounting policies of the Government of Canada set out in Note 2 to the financial statements.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

John Wiersema, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 4, 1999

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 1998

	1998		1997	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
ASSETS				
Denominated in U.S. dollars				
Cash and short-term deposits	**$ 3,536**	**$ 5,422**	$ 2,985	$ 4,270
Marketable securities (Note 4)	**9,327**	**14,301**	9,089	13,002
	12,863	**19,723**	12,074	17,272
Denominated in other foreign currencies				
Cash and short-term deposits (Note 5)	**254**	**390**	226	324
Marketable securities (Note 5)	**3,708**	**5,685**	289	413
	3,962	**6,075**	515	737
Denominated in special drawing rights				
Special Drawing Rights (Note 6)	**1,391**	**2,133**	1,134	1,622
Gold and gold loans (Note 7)	**124**	**191**	148	211
	1,515	**2,324**	1,282	1,833
Official international reserve assets	**$ 18,340**	**$ 28,122**	$ 13,871	$ 19,842

DUE TO THE CONSOLIDATED REVENUE FUND

	1998	1997
Advances (Note 8)	**$ 26,466**	$ 18,506
Revenues for the year	**1,656**	1,336
	$ 28,122	$ 19,842

Approved:

Governor
Bank of Canada

Deputy Minister
Department of Finance

Chief Accountant
Bank of Canada

See accompanying notes to the financial statements

EXCHANGE FUND ACCOUNT
STATEMENT OF REVENUE

FOR THE YEAR ENDED DECEMBER 31, 1998

	1998	1997
	(in millions of Canadian dollars)	
Revenue from investments		
Marketable securities	$ 1,364	$ 1,030
Cash and short-term deposits	257	260
Special drawing rights	69	64
Gold	26	23
	1,716	1,377
Other revenue (loss)		
Gain on sales of gold	253	-
Net foreign exchange gains/(losses)	(313)	(41)
	(60)	(41)
Net revenue for the year due to the Consolidated Revenue Fund	$ 1,656	$ 1, 336

See accompanying notes to the financial statements

EXCHANGE FUND ACCOUNT

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1998

1. AUTHORITY AND OBJECTIVE

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets which are deemed appropriate for this purpose in accordance with the *Currency Act*.

2. SIGNIFICANT ACCOUNTING POLICIES

Significant account policies of the Account are set out below. As required by the *Currency Act*, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements.

a) Valuation of assets

The estimated fair market value of cash and short-term deposits, which are generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and Special Drawing Rights (SDRs) include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of five major currencies (four after January 1, 1999 when the German mark and French franc are replaced by the Euro).

Gold and gold loans include accrued interest. Gold and gold loans are carried in the Account at a value of 35 SDRs per fine ounce, which conforms to the value used in the *Public Accounts of Canada*.

b) Revenue from investments

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Write downs of securities to their year-end market values (if applicable) are recorded as a charge to investment revenue in the year in which they occur.

c) *Gold*

Gold sales and net gains on gold sales are recorded at settlement dates. Interest revenue from gold loans is recorded on an accrual basis and is included in revenue. Premiums received on the sales of call options on gold are recorded in revenue.

d) *Translation of foreign currencies and SDRs*

Assets and liabilities denominated in foreign currencies and SDRs are translated into Canadian and U.S. dollar equivalents at year-end market exchange rates, which were as follows:

	Canadian dollars	
	1998	1997
U.S. dollar	**1.5333**	1.4305
Japanese yen	**0.01350**	0.01096
German mark	**0.9191**	0.7958
French franc	**0.2741**	0.2374
Special Drawing Right	**2.1570**	1.9301

Foreign exchange gains or losses result from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year. Unrealized foreign exchange gains or losses on short-term currency swap arrangements with the Bank of Canada and on currency hedges are recorded in revenue as *Net foreign exchange gains (losses)*. See also Note 9.

The reported amount at year-end of assets that are hedged against exchange rate fluctuations includes unrealized gains or losses on the translation of the related outstanding hedge contracts. See also Notes 5 and 9.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

e) *Disposition of revenues*

The revenues for the year are payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

f) *Services received without charge*

The Account receives without charge administrative, custodial and fiscal agency services from the Bank of Canada.

g) *Interest-free advances*

The Account receives interest-free advances from the Consolidated Revenue Fund.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar, or to meet net government requirements for foreign exchange. During the year, US$ 10,467 million (net) in official international reserves were used for these operations (US$ 4,848 million (net) in 1997). Of these, transactions during the year aimed at moderating movements in the value of the Canadian dollar comprised sales of foreign currency of US$ 9,063 million (US$ 5,326 million in 1997) and purchases of foreign currency of US$ 51 million (US$ 1,665 million in 1997).

4. Marketable Securities Denominated in U.S. Dollars

	1998			1997		
	(in millions of dollars)					
Securities	***Par value***	***Amortized cost***		Par value	Amortized cost	
	US	***US***	***Canadian***	US	US	Canadian
U.S. Government	**$ 5,482**	**$ 5,645**	**$ 8,656**	$ 6,662	$ 6,723	$9,617
U.S. Federal Agencies	**1,856**	**1,855**	**2,844**	1,178	1,166	1,669
Sovereign paper and International Institutions	**1,704**	**1,713**	**2,626**	1,124	1,117	1,598
Accrued interest	**-**	**114**	**175**	-	83	118
	$ 9,042	**$ 9,327**	**$ 14,301**	$ 8,964	$ 9,089	$ 13,002
Estimated market value:		**$ 9,524**	**$ 14,603**		$ 9,200	$ 13,160

Estimated market values are based on quoted market prices.

At year-end, a portion of the Account's holdings of U.S. Government securities consisting of US$ 2,350 million (par values) in Treasury Notes (US$ 2,250 million in 1997) and US$ 425 million in U.S. Treasury Bills (US$ 525 million in 1997) were being used in securities lending operations with financial institutions. Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions.

5. Assets Denominated in Other Foreign Currencies

Cash and Short-term Deposits

	1998		1997	
	(in millions of dollars)			
	US	Canadian	US	Canadian
German marks	$ 252	$ 386	$ 224	$ 322
French francs	1	2	-	-
Japanese yen	1	1	1	1
Accrued interest	-	1	1	1
	$ 254	$ 390	$ 226	$ 324

Marketable Securities

	1998		1997	
	(in millions of dollars)			
	US	Canadian	US	Canadian
German Government	$ 2,747	$ 4,211	$ 26	$ 37
French Government	715	1,097	-	-
Japanese Government	246	377	263	376
Amortized cost at year-end:	$ 3,708	$ 5,685	$ 289	$ 413
Estimated market value at year-end:	$ 3,864	$ 5,925	$ 290	$ 415

Estimated market values are based on quoted market prices.

The Account hedges the U.S. dollar value of some of its holdings of assets denominated in other foreign currencies by entering into forward foreign exchange contracts. As a result of these operations, the Account had year-end commitments for net forward sales of 832 million German marks (463 million in 1997) and 35 billion Japanese yen (30 billion in 1997), against net forward purchases totalling US$ 495 million (US$ 264 million in 1997) and US$ 279 million (US$ 255 million in 1997), respectively. Unrealized exchange losses of C$ 53 million (gains of C$ 45 million in 1997) resulting from these hedging operations are included in the year-end value of the Account's holdings of German marks and Japanese yen and in revenue as *Net foreign exchange gains (losses)*. See also Note 9.

6. Special Drawing Rights (SDRs)

	1998		1997	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at the end of the year	**$ 1,384**	**$ 2,123**	$ 1,126	$ 1,610
Accrued interest	**7**	**10**	8	12
	$ 1,391	**$ 2,133**	$ 1,134	$ 1,622

7. Gold and Gold Loans

During the year, the Account sold 600,000 fine ounces of gold.

	1998		1997	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at the end of the year				
Gold loans	**$ 117**	**$ 180**	$ 141	$ 201
Gold	**5**	**8**	5	7
Accrued interest on gold loans	**2**	**3**	2	3
	$ 124	**$ 191**	$ 148	$ 211

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

		1998		1997	
		Price per fine ounce	***Total value in millions***	Price per fine ounce	Total value in millions
Carrying value	- US	**$ 49.24**	**$ 122**	$ 47.22	$ 146
	- Canadian	**75.50**	**188**	67.55	208
Market value	- US	**287.45**	**715**	289.20	893
	- Canadian	**440.75**	**1,096**	413.70	1,277

8. Due to the Consolidated Revenue Fund (CRF) - Advances

The Account is funded by advances from the CRF. Advances are limited to C$ 35 billion by Order-in-Council. At year-end, advances from (deposits with) the CRF consisted of:

	1998	1997
	(in millions of Canadian dollars)	
U.S. dollars	**$ 45,951**	$ 26,839
Canadian dollars	**(24,340)**	(8,407)
German marks	**3,676**	-
French francs	**1,096**	-
Special Drawing Rights	**83**	74
	$ 26,466	$ 18,506

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on SDR allocations to Canada are charged directly to the CRF.

Canadian dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

9. Commitments

a) Currency swaps

The Account enters into short-term currency swap arrangements with the Bank of Canada. The objective of these swaps is to assist the Bank in its cash management operations. Under these agreements, the Account sells U.S. government securities denominated in U.S. dollars for Canadian dollars, with simultaneous agreements to repurchase these securities from the Bank on future dates at the same exchange rates in effect at the time the swaps were entered into. The maximum term of the swaps is equivalent to the term of the underlying securities; however, they are generally reversed earlier based on operational requirements of the Bank.

These swaps result in receipts of Canadian dollars by the Account, which are remitted to the Consolidated Revenue Fund. These transactions are reversed when the swaps mature.

At year-end, the Account had commitments to repurchase U.S. dollar securities under swap arrangements with the Bank of Canada of US$ 2,941 million (US$ 2,430 million in 1997). The Canadian dollar equivalent at the year-end exchange rate was $4,509 million ($3,476 million in 1997).

b) *Currency hedges and other uncompleted transactions*

Hedges of the Account's holdings of German marks and Japanese yen resulted in year-end commitments for net forward sales of 832 million German marks (463 million in 1997) and 35 billion Japanese yen (30 billion in 1997), against total net forward purchases of US$ 774 million (US$ 519 million in 1997). The maturity dates of these contracts extend until June 1999.

c) *Gold options and forward contracts*

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings.

Under gold options, the Account receives a premium against commitments to sell gold at predetermined prices. No gold is sold unless the holders of the options exercise their rights by the expiry dates. At year-end, the Account had outstanding commitments to sell 200,000 fine ounces of gold under call option contracts (90,000 fine ounces in 1997) with a potential total value, if the options were exercised, of US$ 63 million (US$ 31 million in 1997). These options mature by the end of the first quarter in 1999.

Under forward contracts, the Account is committed to sell gold at predetermined prices on future dates. At year-end, the Account had outstanding commitments to sell 270,000 fine ounces of gold (444,000 fine ounces in 1997) for a total value of US$ 82 million (US$ 152 million in 1997). The dates of these contracts extend until August 1999.

10. Uncertainty Due to the Year 2000 Issue

The Year 2000 computer issue arises chiefly because many date-sensitive automated systems have not been designed to recognize correctly the year 2000. This represents a significant challenge for all organizations. If not addressed properly, the Year 2000 issue could have an impact on operations and financial reporting, ranging from minor errors to the failures of critical systems. The effects of the Year 2000 issue could be experienced before, as well as on or after, January 1, 2000.

The Bank of Canada, the fiscal agent for the Account, has a business plan for dealing with the Year 2000 issue. The objectives of that plan are to ensure that the Bank's critical internal systems will function properly, to co-ordinate with business partners the testing of shared systems, and to ensure that appropriate contingency plans are in place in the event of disruptions or system failures. Since 1997, the Bank has had a team assigned solely to implementation of the plan, which entails the overall management, direction and support of Year 2000 initiatives.

However, it is not possible to be certain that all aspects of the Year 2000 issue, including those related to the efforts of financial institutions or other third parties, will be fully resolved.

ANNUAL REPORT TO PARLIAMENT
ON THE OPERATIONS OF THE
EXCHANGE FUND ACCOUNT
BY THE MINISTER OF FINANCE
AND
REPORT OF THE AUDITOR GENERAL
TO THE MINISTER OF FINANCE
ON THE EXAMINATION OF THE
ACCOUNTS AND FINANCIAL STATEMENTS
OF THE EXCHANGE FUND ACCOUNT
1999

(AUSSI DISPONIBLE EN FRANÇAIS)

EXCHANGE FUND ACCOUNT

ANNUAL REPORT

DECEMBER 31, 1999

INTRODUCTION

This report reviews the operations of the Exchange Fund Account ("EFA") for the 1999 calendar year and the changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying Financial Statements provide additional information on the operations of the EFA.

The Exchange Fund Account is the principal repository of Canada's official international reserves. The EFA is governed by the provisions of the *Currency Act* and is held in the name of the Minister of Finance. Foreign currency borrowings by the Government of Canada are the main source of financing of the EFA.

Objectives

The objectives of the EFA are:

- to promote orderly conditions in the foreign exchange market for the Canadian dollar;
- to provide general liquidity for the government; and
- to minimize the cost of carry of the government's foreign currency liabilities used to fund the EFA's assets, with due attention to risk management.

Governance

The Minister of Finance approves the general policies related to the management of the EFA and provides an annual report to Parliament on the operations of the Account. Responsibility for the management of the EFA is jointly shared by the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, effects transactions for the Account.

The Director, Financial Markets Division (Department of Finance) and the Chief, Financial Markets Department (Bank of Canada) are responsible for the on-going management of the EFA. A Policy Committee, comprised of senior management of the Department of Finance and the Bank of Canada in the form of the Assistant Deputy Minister, Financial Sector Policy Branch (Department of Finance) and the Deputy Governor (Bank of Canada), meets semi-annually to review developments, approve major policy initiatives and provide guidance and accountability on the management of the Account.

The Risk Management Unit (RMU), established by the Department of Finance and Bank of Canada to oversee the risk position of the Government of Canada, monitors and advises on the risk position of the EFA, including market, credit and liquidity risks.

Key Principles

Principles governing the management of the EFA include:

- There should be a sufficient amount of high-quality, highly-liquid foreign exchange reserve assets available for intervention and general liquidity purposes;
- The difference between the interest paid on the government's foreign currency liabilities used to fund EFA assets and the interest earned on those assets should be minimised (to the extent that the former is higher);

- Foreign reserves should be managed to ensure, as much as possible, that the assets match the liabilities in currency and duration;
- Credit risk should be managed prudently through diversification of the EFA asset portfolio, with appropriate use of credit ratings and counterparty limits; and
- Foreign currency borrowing activities to fund EFA assets should be conducted so as to maintain Canada's reputation as a successful borrower in international capital markets.

Management of the EFA: Recent Developments

In October 1999, the Minister of Finance approved a new structure for the government's foreign exchange reserve asset portfolio held in the EFA, including new investment guidelines for the management of the portfolio. These changes are important in helping to:

- ensure that the EFA asset portfolio is structured so that the Exchange Fund Account will continue to be able to meet its liquidity and investment objectives; and
- increase the investment flexibility of the portfolio in order to reduce costs, while ensuring that the government's risk exposure on the portfolio is prudently managed and diversified.

With respect to structure, the EFA asset portfolio is divided into two Tiers: a Liquidity Tier and an Investment Tier. The Liquidity Tier consists of U.S. dollar denominated shorter-term, liquid assets of the highest credit quality, which are available for intervention in support of the Canadian dollar and for government liquidity requirements. The Investment Tier is larger than the Liquidity Tier and consists of a diversified portfolio of primarily longer-term assets of high credit quality. Investment Tier assets may be denominated in US-dollars, Euro or Yen.

In terms of the currency composition of the portfolio, a minimum share of 50% of EFA assets must be denominated in U.S. dollars. This requirement reflects the leading role of the U.S. dollar as a reserve currency and the fact that the U.S. dollar is the traditional currency through which the Bank of Canada (on behalf of the government) has intervened in support of the Canadian dollar. The remainder of the portfolio in excess of the mandated minimum level of U.S. dollar holdings is split among U.S. dollar, Euro and Yen-denominated assets depending on the relative funding and investing opportunities in each currency, although relatively small minimum amounts of Euro and Yen are maintained at all times in the event of concerted international foreign exchange intervention.

With respect to the new investment guidelines, the EFA may hold debt issued in the designated currencies by highly rated sovereign governments, their agencies and by supranational organizations. Eligible issuers must have an AA- rating or better from two of five designated rating agencies (S&P, Moody's, Fitch IBCA, Dominion Bond Rating Service and Canadian Bond Rating Service), one of which must be either Moody's or S&P. The EFA may also make deposits and execute other transactions with commercial financial institutions meeting the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Enhanced Foreign Exchange Reserves Disclosure

Commencing with the June 1999 Official International Reserves press release, the Government of Canada became one of the first countries to provide enhanced reserves disclosure in

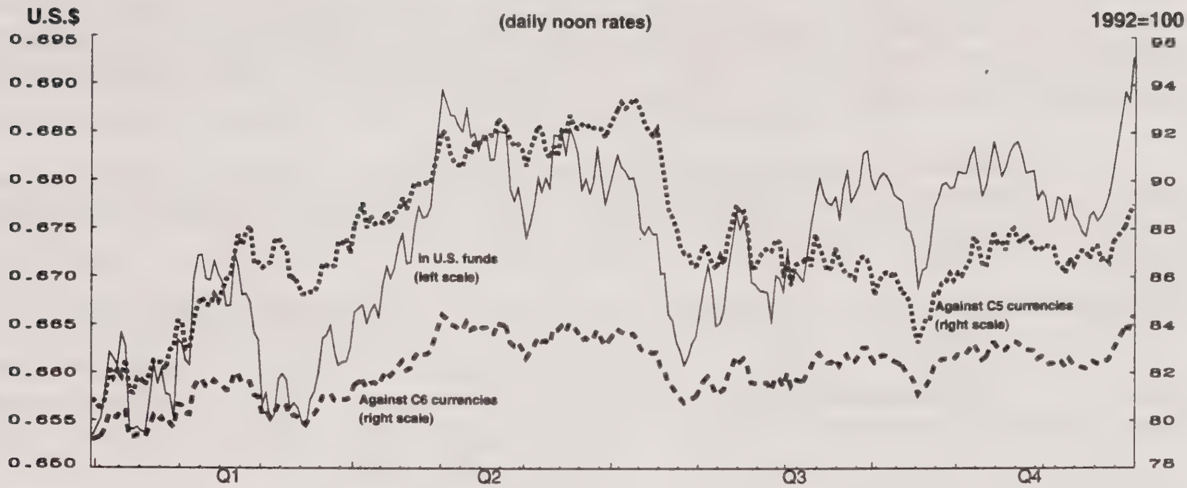
a manner consistent with the standards established by the International Monetary Fund and the G-10 central banks. Initiatives to enhance international standards for reserves disclosure reflect the broad international consensus that more comprehensive and timely reserves data would help reduce the possibility of financial crises. An important feature of the enhanced reserve reporting is to provide more extensive, disaggregated data - for example, Canada now reports its reserve position weekly and data related to foreign currency liabilities and off-balance sheet transactions are disclosed on a monthly basis.

The June 1999 press release also marked the switch from a book value to a market value basis for the public reporting of Canada's official international reserves. Where possible, this report provides 1999 data on both a book value and a market value basis. The book value basis is provided for historical comparison purposes while the market value data will be the basis for future reporting.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

The Canadian dollar strengthened over the year, gaining almost four U.S cents (or 6.2 per cent) against the U.S. dollar, finishing the year at US$0.6929. The dollar's high for the year was US$0.6935 recorded on December 31 while the low for the year was US$0.6462 recorded on January 13. On a trade weighted basis against the C6[1] currencies the Canadian dollar appreciated by 6.6 per cent, slightly more than it rose against the U.S. dollar alone. This is explained by the fact that the Canadian dollar appreciated by over 10 per cent against the C5 currencies.

CANADIAN DOLLAR EXCHANGE RATES



INTERNATIONAL FINANCIAL DEVELOPMENTS DURING 1999

The global economic environment improved in 1999. Interest rate reductions by the major central banks in the latter part of 1998 helped to rebuild investor confidence and to calm global financial markets. Corporate and emerging market interest rate spreads over government debt also normalized over the year.

Overall, the year 1999 can be divided into two periods. The first part, extending from January to May, was characterized by mixed, yet generally improving growth prospects among the industrialized countries. Then, as the year progressed, concerns about inflation rekindled as growth accelerated in major countries, leading to interest rate increases by some central banks.

(I) FIRST HALF OF 1999 - ECONOMIC CONDITIONS BEGIN TO SHOW SIGNS OF IMPROVEMENT

Early in 1999, most estimates of world economic growth had been revised downwards, with a marked divergence noted among G-7 countries.

In Europe, economic activity was softening, although there were reasons for optimism. First, the introduction of the euro currency had been smooth. (On January 1, Austria, Belgium, France,

---

1. With the advent of the euro on January 1, 1999, the former G-10 index (which included the German mark, French franc, Italian lira, Belgian franc and Dutch guilder) was replaced by a C-6 trade-weighted index which includes the U.S. dollar, euro, Japanese yen, U.K. pound, Swiss franc and Swedish krone. Similarly, a C-5 index replaced the G-9 index, which excluded the U.S. dollar.

Finland, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain, 11 of the 15 member countries of the European Union, joined in a currency union - the European Economic and Monetary Union (EMU), resulting in the adoption of the euro). In addition, conditions outside Europe were improving, and interest rates had been reduced, including a 50 basis point cut to 2.50 per cent by the European Central Bank in mid-April.

In Japan, the economy started the year in deep recession and prospects for recovery were dim. However, government spending led to a sharp rebound in growth in the first half of 1999.

The U.S. economy continued to grow vigorously, outperforming most expectations. The Canadian economy started 1999 on a stronger note, with sustained U.S. demand providing an important offset to weak commodity prices and lower demand from Asian countries. In the context of a calmer financial environment, the Bank of Canada cut the Bank Rate by 25 basis points on two occasions, bringing the rate to 4.75 per cent by early May.

The Canadian dollar appreciated from about US$0.6552 in January to US$0.6894 in early May, supported by firming domestic demand, an improving current account balance and more stable world commodity prices.

(II) SECOND HALF OF 1999 - STRONGER GROWTH RAISES CONCERNS ABOUT INFLATION

The outlook for the global economy continued to improve in the second part of the year, while inflation in the major economies remained subdued. In all, the economic outlook for the major industrial countries, with the exception of Japan, showed less divergence in the latter part of the year.

The pace of economic expansion accelerated in the euro area from the below potential growth seen in the first half of the year. By early-November, the European Central Bank had raised interest rates by 50 basis points to 3.00 per cent, noting that its move would help restrain inflation expectations.

Japan, which had grown sharply in the first half of the year, saw output decline after the fiscal support diminished.

In the U.S., GDP growth accelerated further. Although inflation remained subdued, concerns about inflationary pressures were rekindled. In response, the Federal Reserve raised the federal funds target by 25 basis points on three occasions from June to November to reach 5.50 per cent. The rate hikes fully reversed the reductions implemented in reaction to the financial market turbulence in the autumn of 1998.

The Canadian economy also expanded further, supported by the strong U.S. economy, improving domestic demand and recovering Asian economies and world commodity markets. In mid-November, the Bank of Canada raised the Bank Rate by 25 basis points to 5.00 per cent. For most of the period from May to November, the Canadian dollar fluctuated in a range of US$0.6662 to US$0.6894.

Towards year end, various central banks announced contingency arrangements for the period around the year-2000 date change. Likewise, financial market participants took precautions to avoid technical problems over the period, resulting in even quieter-than-normal holiday markets. In any event, the transition to the year 2000 went smoothly.

FINANCIAL REVIEW

1. Foreign Exchange Market Intervention

The objectives of the Exchange Fund Account are to promote orderly conditions in the foreign exchange market for the Canadian dollar and to provide general liquidity for the government. Since September 1998 the Bank of Canada, acting as agent for the Department of Finance, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of U.S. dollars versus the Canadian dollar (see Table 1).[2]

Canada's intervention practices have varied with changes in market conditions. In recent years, intervention has generally been less frequent, reflecting the maturity of the foreign exchange market. However, when required, intervention has often been for greater amounts, reflecting larger market flows and occasionally the increased volatility of the exchange rate.

In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling foreign exchange / buying Canadian dollars when there was downward pressure on the exchange rate, or buying foreign exchange / selling Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

Table 1

FOREIGN EXCHANGE MARKET INTERVENTION

	1995	1996	1997	1998	**1999**
			(in millions of U.S. dollars)		
Purchases	5,167	225	1,665	51	**0**
Sales	-5,509	-1,241	-5,326	-9,063	**0**
Net	-342	-1,016	-3,661	-9,012	**0**

2. Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

2. CANADA'S OFFICIAL INTERNATIONAL RESERVES

The Exchange Fund Account is the principal repository of Canada's official international reserves; Canada's foreign assets at the Bank of Canada and the International Monetary Fund are also included in the total of reserves. The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2

CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31

	Book Value		Market Value	Of which:			
	1998 Total	**1999 Total**	**1999 Total[1]**	Exchange Fund Account	Bank of Canada	Minister of Finance	Receiver General for Canada
			(in millions of U.S. dollars)				
Convertible foreign currencies[2]:							
U.S. dollars	15,907	**19,170**					
Other	4,004	**5,781**					
Securities (Market Value)			**21,033**	17,578	3,455	-	-
Deposits (Market Value)			**3,399**	3,292	102	-	5
Gold[3]	122	**87**	**524**	524	-	-	-
Reserve position in the IMF	2,297	**3,164**	**3,164**	-	-	3,164	-
Special drawing rights	1,097	**526**	**526**	526	-	-	-
Total holdings	23,427	**28,728**	**28,646**	21,920	3,557	3,164	5

1. The classification of assets in the Statement of Official International Reserves differs from that used in the attached financial statements.
2. The different categories used in this table for book value and market value reflect the change in reporting categories introduced in the June 1999 Official International Reserves press release.
3. From June 30 onward, gold reserves were revalued on a market value basis for reporting purposes. This resulted in an upward revaluation of US$469 million based on the difference between the historical carrying cost (SDR 35 or about US$46.75 per ounce) and the June 30 market price of US$261 per ounce.

   The EFA sold gold on a forward basis during the year, for delivery and settlement in both 1999 and 2000. A total of 681,000 ounces were delivered and settled in 1999 (including 270,000 ounces which had been originally sold forward in 1998 and zero ounces as a result of options being exercised). At year end, the EFA had commitments for sales of 622,000 ounces of gold in 2000 for a total value of US$162.1 million.

Canada's official reserves ended the year at US$28.6 billion on a market value basis. Reserves grew on a book value basis by US$5.3 billion to US$28.7 billion. The increase in the level of reserves over this period was funded in foreign markets using various short, medium and long-term debt issues, swapped domestic issues and spot foreign exchange purchases. These financing activities are set out in greater detail in Table 6. As indicated by the Minister of Finance in the 1996 and 1998 budgets, Canada has moved to increase the level of its foreign exchange reserves, in response to increased flows in foreign exchange markets and in order to maintain a prudent level of liquid reserves in line with other comparable countries.

Table 3 below outlines the main factors affecting the level of reserves:

Table 3A

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES
(book value)

	1998 Book Value	**1999 Book Value**
	(millions of U.S. dollars)	
Market Intervention	-9,012	**0**
Other official transactions[1]	-1,457	**2,744**
Net borrowings including cross-currency swaps	14,138	**1,889**
Foreign currency earnings	1,228	**1,085**
Net proceeds of gold sales	168	**166**
Foreign currency revaluation	400	**-621**
Other	-7	**38**
Total holdings	5,458	**5,301**

Table 3B

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value)

	1999 Market Value
	(millions of U.S. dollars)
Official intervention	**0**
Net government operations[1]	**4,426**
Foreign currency debt including cross-currency swaps	**1,946**
Gains and Losses on Gold Sales	**16**
Return on investments[2]	**-6**
Foreign currency debt charges	**-1,683**
Foreign currency revaluation	**-587**
Other	**0**
Total holdings	**4,112**

1. Under the previous reserves reporting regime the category *other official transactions* was an aggregate measure of the net use of reserves during the year to meet the currency requirements of the government, including foreign debt servicing, payments and contributions to international institutions and foreign expenditures of government departments. Under the new disclosure regime *other official transactions* is now disaggregated into *official intervention* and *net government operations*, the latter covering net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.
2. *Return on investments* is now comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates, while *gains and losses on gold sales* reflects the degree to which proceeds from the sale of gold exceeds the market value of gold that existed at the end of the previous month.

More detailed information on monthly levels and changes in Canada's reserves is presented in Table 7.

3. Term Structure of EFA Investments and Liabilities

Table 4

TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS AND LIABILITIES AS AT DECEMBER 31, 1999

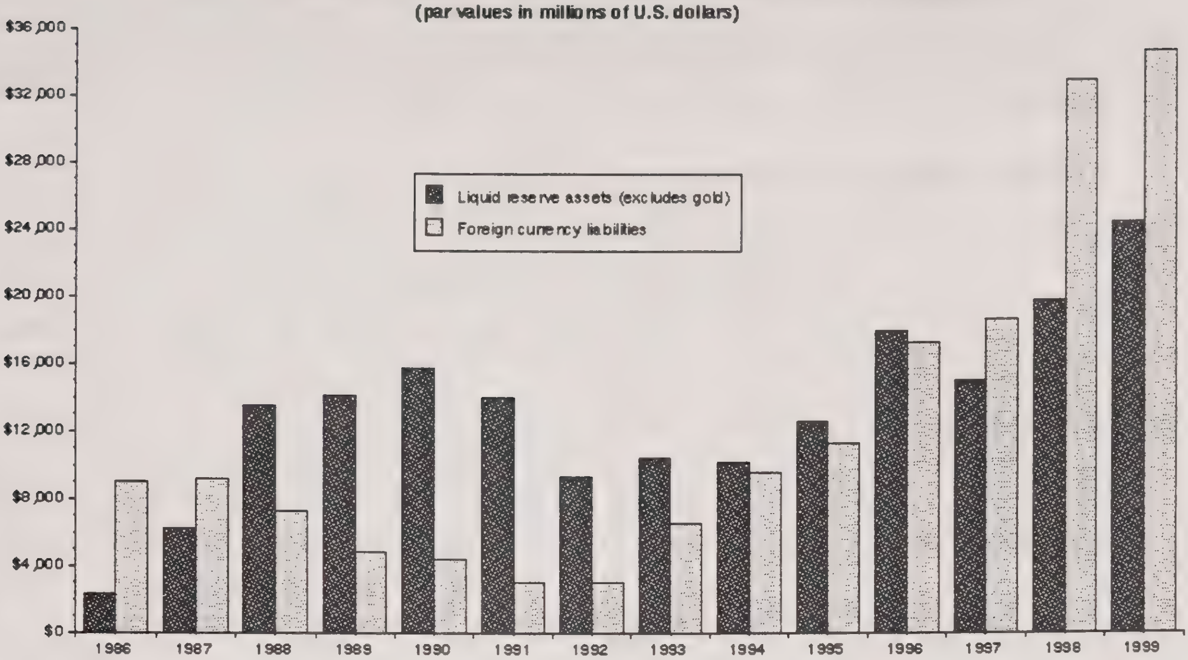
(par values[1] in millions of U.S. dollars)

	Foreign currency investments				
Duration	Cash and term deposits	Government securities in domestic currency	Other securities	Total assets[2]	Foreign currency liabilities
US DOLLAR HOLDINGS					
Under 6 months	3,564	300	2,436	6,300	5,110
6 to 12 months	-	-	-	-	44
1 to 5 years	-	4,683	3,087	7,769	11,981
Over 5 years	-	3,118	1,561	4,679	11,748
EURO HOLDINGS					
Under 6 months	24	-	-	24	-
6 to 12 months	-	-	-	-	-
1 to 5 years	-	1,512	70	1,583	1,629
Over 5 years	-	3,013	631	3,644	3,925
YEN HOLDINGS					
Over 5 years	-	488	-	488	416
TOTAL	**3,588**	**13,114**	**7,785**	**24,487**	**34,853**

1. Data in this table reflect the par value of investments. In the attached Financial Statements, investments are reported at their book value which includes unamortized premiums or discounts where applicable and accrued interest. It is expected that next year's EFA annual report will report this table on a market value basis.
2. Includes US$3,483 million (par value) of U.S. Government securities held temporarily by the Bank of Canada at year end, under short-terms asset swaps. See also note 9(a) to the Financial Statements that references these swaps.

Foreign exchange liabilities have grown significantly in recent years, particularly in 1998 due to extensive foreign exchange intervention and important commitments to the International Monetary Fund. As a result, foreign currency liabilities grew to exceed foreign currency assets in the EFA (see Graph 1). Purchases of US dollars in the foreign exchange markets are being used to reduce the mismatch between foreign currency liabilities and assets. The government plans to continue to bring foreign currency liabilities in line with foreign currency assets in an orderly and prudent manner over the next few years.

GRAPH 1 - CANADA'S FOREIGN EXCHANGE RESERVES AND LIABILITIES, 1986-1999
(par values in millions of U.S. dollars)



4. THE EXCHANGE FUND ACCOUNT'S REVENUES

The Exchange Fund Account's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 1999, the EFA's income totalled C$1,935 million, compared with C$1,656 million in 1998. Income earned by other reserve holders is added to official reserves, but is reported directly by those other entities.

The main categories of income earned by the EFA are summarized below:

Table 5

EXCHANGE FUND ACCOUNT INCOME SUMMARY

	1995	1996	1997	1998	**1999**
			(in millions of Canadian dollars)		
INVESTMENT INCOME					
Marketable securities	758	961	1,030	1,364	**533**
Cash and short-term deposits	188	197	260	257	**237**
Special drawing rights	79	63	64	69	**33**
Gold	17	26	23	26	**14**
Total Investment Income	1,042	1,247	1,377	1,716	**817**
OTHER INCOME					
Gains on gold sales	214	156	-	253	**247**
Foreign exchange gains (losses)	127	(101)	(41)	(313)	**871**
TOTAL INCOME	1,383	1,302	1,336	1,656	**1,935**

Pursuant to Note 2a of the financial statements, EFA assets are valued at the lower of their amortized cost (including accrued interest) and their year-end market values. This led to a write down of C$640 million in the value of the EFA's assets in 1999 (see Notes 4 and 5 of the financial statements for details on this write down). Interest rate increases in the U.S. (2-year Treasury yields increased 170 bp, 5-year Treasury yields increased 180 bp and 10-year Treasury yields increased 180 bp) and Europe (2-year Bund yields increased 110 bp, 5-year Bund yields increased 148 bp and 10-year Bund yields increased 150 bp) caused the market value of the EFA's assets to decrease over the year, while the weakness of the euro vis-à-vis the U.S. dollar (from US$1.1723 to US$1.0063) resulted in a translation loss as euro denominated assets are reported in U.S. dollars. These factors were the primary causes of the write down of the EFA assets.

At year end, the EFA's portfolio of marketable securities consisted entirely of discount and fixed-rate securities; there were no floating rate investments held.

The EFA's securities lending programs enhance the yield earned on its securities portfolio by lending out to counterparties securities which are highly sought after in the market. However, at year end, no U.S. Government securities were held by financial institutions that act as agents for on-lending these securities in the market. (The lending program was temporarily suspended in late 1999 in order that all EFA securities would be available on a contingency basis for Y2K-related concerns.) Similarly, at the end of its first year in operation, there were no euro-denominated securities on loan to eligible counterparties. This compares with a total of US$ 2,775 million in U.S. government securities on loan at the end of 1998. Income from securities lending was US$4.6 million in 1999.

The EFA continues to lend gold in the market on a short term basis, periodically using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans and to establish rollover rates on these loans prior to their maturity. It also continued sales of call options on part of the gold holdings. Income from these activities is reported as investment income on gold.

5. Financing of EFA Assets

EFA foreign currency reserves are financed by foreign currency borrowings by the government (see Table 6). Currently, all foreign currency marketable assets are matched by foreign currency borrowings. In addition, because of heavy intervention in support of the Canadian dollar in 1998, there are currently more foreign currency liabilities than foreign currency assets (i.e. a portion of foreign currency liabilities is not matched by foreign currency assets). As indicated earlier, the government plans to continue to bring foreign currency liabilities in line with foreign currency assets in an orderly way over the next few years.

Table 6

FOREIGN CURRENCY ISSUES
AS AT DECEMBER 31

	1998	**1999**
	(in millions of U.S. dollars)	
Bonds	13,217	**15,038**
Canada Bills	6,622	**3,293**
Swapped domestic issues	8,341	**12,807**
Floating Rate Note	2,000	**-**
Canada Notes	416	**661**
Euro Medium Term Notes	2,485	**3,054**
TOTAL	33,081	**34,853**

6. Cost of the EFA

To calculate the cost of the EFA one can use the interest paid on foreign currency borrowings. Off-setting that cost is the interest earned on the EFA's foreign currency assets. As the EFA is currently in a net foreign currency liability position there is a proportion of liabilities that cannot be matched to any foreign currency asset revenues. In order to calculate the true economic cost of the EFA it is necessary to include an estimate of the revenues that are associated with that excess foreign currency liability position.

In order to estimate the revenues earned on the net foreign currency liability portion of the EFA it is necessary to realize that sales of foreign currency assets used for intervention produce Canadian dollar cash and, therefore, these Canadian dollars can be considered as a substitute for Canadian dollar borrowings. The cost of short-term Canadian dollar liabilities over the same period (since unmatched foreign currency liabilities are largely short-term, floating-rate liabilities) can be used to estimate revenues associated with the excess foreign currency liability position.

Beyond the difference in costs and estimated revenues on the excess foreign currency liability position, there is the risk that the cost will increase because of foreign exchange rate changes. This is why the excess liability position is being eliminated.

Following the above approach, the cost of funding the EFA in 1999 was estimated at between C$1,730 million and C$1,780 million, compared to total income for the EFA of C$1,935 (Table 5).

7. Risk Management and Financial Instruments

The role of the EFA as principal repository of Canada's official reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

Credit Risk

The main criteria for designating institutions, governments, and their agencies whose securities or notes can be purchased or with which deposits can be made, is the credit rating assigned by prominent international and domestic credit agencies. To ensure that the EFA asset portfolio is prudently diversified with respect to credit risk, the investment guidelines specify limits on holdings by class of issuer (sovereign, agency, supranational or commercial financial institution) and type of instrument, while there are further limits on exposure to any one issuer or counterparty.

Liquidity Risk

The EFA's liquidity management is designed to provide a level of liquid assets sufficient to meet the requirements of foreign exchange market intervention, disbursements related to maturing foreign currency borrowings, or the costs of foreign currency debt servicing and other government departmental currency requirements. Liquidity risk management is especially important for the EFA given that intervention requirements are inherently unpredictable. Liquidity management in the EFA therefore includes the management of cash balances and short-term investments. At year end, assets with less than six months to maturity represented 26% of the EFA's portfolio.

Liability management is also an important element of liquidity management given that the EFA is largely funded by foreign currency borrowings, including a US dollar commercial paper program (see "Canada Bills" in Table 6). The government manages foreign currency borrowings so as to typically keep total liabilities on foreign currency borrowings coming due within one year to an amount that is less than one-third of total liquid foreign currency assets. At year-end, total EFA liabilities coming due within one year were US$5,154 million, as compared to total liquid assets of US$24,487 million.

Interest Rate Risk

Interest rate risk arises from differences in the duration of assets and liabilities, or from the need to liquidate investments prior to maturity to meet disbursements. Risk is minimized by managing the duration structure of the EFA's assets and implicit liabilities; by maintaining portfolios of short-term and longer-term investments; and by monitoring gaps in the duration structures or in the relative levels of interest rates on assets and implicit liabilities. Liabilities used as reference for risk management are the foreign currency borrowings of the CRF, the proceeds of which have been advanced to the EFA.

Foreign Exchange Risk

Due to the nature of the EFA's holdings, fluctuations in the value of the U.S. dollar vis-à-vis the Canadian dollar are reflected in income for the year. To a large extent, however, EFA assets are funded by liabilities denominated in the same currency so as to minimize foreign exchange risk. Such an asset/liability matching framework eliminates much of the foreign exchange exposure on euro and Japanese yen assets (all of the EFA's assets and liabilities which had been initially denominated in German marks or French francs were redenominated into euro early in the year).

Gold Loans and Gold Sales

The EFA lends most of its gold on a short-term basis to financial institutions and to major gold trading firms. Gold loans are secured by the provision of collateral by borrowers, in the form of letters of credit or promissory notes issued by major financial institutions. The EFA has made use of forward agreements to obtain higher yields on its gold loans. Under such agreements, during periods where loan rates are volatile, interest rates on the renewal of loans are fixed in advance of the renewal date.

The EFA sells gold in spot and forward markets. Under forward contracts, the EFA is committed to selling gold at future dates for predetermined prices. It also sells call options on a portion of its gold holdings. Under call options contracts, the EFA receives a premium against commitments to sell gold at predetermined dates and prices, at the option holders' discretion.

Securities Lending

The EFA's US dollar-denominated securities lending program involves lending securities through agents to various counterparties. These loans are secured through collateral provided by the counterparties, as well as the guarantee of the agent. Income flows from the underlying securities continue to accrue to the EFA while they are on loan.

A euro-denominated securities lending program was initiated in the latter half of the year. It involves lending euro-denominated securities directly to various counterparties. These loans are secured through collateral provided by the counterparties. Income flows from the underlying securities continue to accrue to the EFA while they are on loan.

Table 7A

CANADA'S OFFICIAL INTERNATIONAL RESERVES[1]

(book value in millions of U.S. dollars)

Month End	Foreign Currencies						Month-to-Month Changes	of which					
	U.S. Dollars	Other[2]	Gold[3]	Special Drawing Rights[4]	Reserve Position in the IMF[4 5]	Total	Total Monthly Change	Net Borrowings or Repayments in Foreign Currency	Gain on Gold Sales	Earnings on Investments	Revaluation Effects	Official Government Operations[6]	Other Transactions
1998													
December	15,907	4,004	122	1,097	2,297	23,427							
1999													
January	16,238	3,649	121	1,083	2,354	23,445	18	-168	-	134	-173	226	-1
February	15,421	3,437	119	366	3,012	22,355	-1,090	-1,191	-	73	-236	258	6
March	17,233	4,255	111	456	2,903	24,958	2,603	2,398	41	93	-41	112	-
April	17,610	4,152	104	454	2,997	25,317	359	-234	33	143	-110	527	-
May	17,550	4,098	103	467	2,982	25,201	-116	-497	-	131	-76	326	-
June	17,527	4,644	102	464	2,963	25,700	499	14	-	81	-1	387	18
July	16,912	5,038	101	474	3,025	25,550	-150	-405	20	91	256	-120	8
August	16,947	5,082	93	492	3,111	25,725	175	-78	43	70	-10	150	-
September	17,033	5,312	88	499	3,211	26,143	418	-100	29	45	120	327	-3
October	17,333	5,573	87	496	3,195	26,684	541	325	-	41	-87	266	-4
November	19,478	5,575	87	510	3,170	28,820	2,136	1,998	-	83	-248	302	1
December	19,170	5,781	87	526	3,164	28,728	-92	-173	-	100	-15	-17	13

1. Due to a different accounting treatment for accrued earnings on SDR-denominated assets and year-end revaluation of holdings of other currencies and the investment portfolio, the numbers in this table differ slightly from the corresponding numbers in the attached Financial Statements.
2. Valued at closing market rates in terms of U.S. dollars.
3. Gold is valued at SDR 35 per ounce.
4. SDR-denominated assets are valued at the U.S. dollar rate the SDR established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
5. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.
6. Official government operations include purchases and sales of foreign exchange aimed at moderating movements in the Canadian dollar and net government requirements of foreign exchange.

Table 7B

CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value in millions of U.S. dollars)

Month End	Foreign Currencies						Month-to-Month Changes	of which						
	Securities	Deposits	Gold[1]	Special Drawing Rights[2]	Reserve Position in the IMF[2 3]	Total	Total Monthly Change	Foreign Currency Debt	Gains and Losses on Gold Sales	Return on Investments[4]	Foreign Currency Debt Charges	Revaluation Effects	Net Government Operations[5]	Other
1998														
December	16,622	3,803	715	1,097	2,297	24,534								
1999														
January	16,885	3,505	710	1,083	2,354	24,537	3	-168	-	-9	-99	-47	326	-
February	16,007	3,041	714	366	3,012	23,140	-1,397	-1,191	-	-309	-160	-154	417	-
March	18,750	2,854	650	456	2,903	25,613	2,473	2,398	3	111	-179	-151	291	-
April	18,571	3,359	628	454	2,997	26,009	396	-234	2	166	-80	-65	607	-
May	17,860	3,684	589	467	2,982	25,582	-427	-497	-	-140	-75	-115	400	-
June	18,943	2,864	572	464	2,963	25,806	224	66	-	-105	-202	-124	589	-
July	18,787	2,786	540	474	3,025	25,612	-194	-394	3	89	-248	228	128	-
August	18,471	3,143	495	493	3,111	25,713	101	-79	8	44	-101	-22	251	-
September	19,017	2,969	540	499	3,211	26,236	523	-93	-	94	-183	194	511	-
October	19,562	2,975	540	496	3,195	26,768	532	318	-	18	-18	-70	284	-
November	20,837	3,854	526	510	3,170	28,897	2,129	1,995	-	77	-208	-244	509	-
December	21,033	3,399	524	526	3,164	28,646	-251	-175	-	-42	-130	-17	113	-

1. Gold valuation is based on the London p.m. fix on the last business day of the reporting month.
2. SDR-denominated assets are valued at the U.S. dollar rate the SDR established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
3. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.
4. Return on investments are comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates.
5. Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

EXCHANGE FUND ACCOUNT

FINANCIAL STATEMENTS

DECEMBER 31, 1999

MANAGEMENT RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies of the Government of Canada set out in Note 2 to the financial statements. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of his audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are part of the Public Accounts and are referred to the Standing Committee on Public Accounts for their review.

G.G. Thiessen
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

F.J. Mahoney
Chief Accountant
Bank of Canada

AUDITOR GENERAL OF CANADA

VÉRIFICATEUR GÉNÉRAL DU CANADA

AUDITOR'S REPORT

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 1999 and the statement of revenues for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting policies used and significant estimates made by the Account's management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 1999 and its revenues and its cash flows for the year then ended in accordance with the accounting policies of the Government of Canada set out in Note 2 to the financial statements.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

John Wiersema, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 1, 2000

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 1999

	1999		1998	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
ASSETS				
Denominated in U.S. dollars				
Cash and short-term deposits	**$ 3,575**	**$ 5,160**	$ 3,536	$ 5,422
Marketable securities (Note 4)	**11,696**	**16,881**	9,327	14,301
	15,271	**22,041**	12,863	19,723
Denominated in other foreign currencies				
Cash and short-term deposits (Note 5)	**24**	**35**	254	390
Marketable securities (Note 5)	**5,564**	**8,030**	3,708	5,685
	5,588	**8,065**	3,962	6,075
Denominated in special drawing rights				
Special Drawing Rights (Note 6)	**529**	**764**	1,391	2,133
Gold and gold loans (Note 7)	**88**	**127**	124	191
	617	**891**	1,515	2,324
Official international reserve assets	**$ 21,476**	**$ 30,997**	$ 18,340	$ 28,122
DUE TO THE CONSOLIDATED REVENUE FUND				
Advances (Note 8)		**$ 29,062**		$ 26,466
Revenues for the year		**1,935**		1,656
		$ 30,997		$ 28,122

Approved:

G.G. Thiessen
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

F.J. Mahoney
Chief Accountant
Bank of Canada

See accompanying notes to the financial statements

EXCHANGE FUND ACCOUNT
STATEMENT OF REVENUE

FOR THE YEAR ENDED DECEMBER 31, 1999

	1999	1998
	(in millions of Canadian dollars)	
Revenue from investments		
Marketable securities	**$ 533**	$ 1,364
Cash and short-term deposits	**237**	257
Special drawing rights	**33**	69
Gold	**14**	26
	817	1,716
Other revenue (loss)		
Gain on sales of gold	**247**	253
Net foreign exchange gains (losses)	**871**	(313)
	1,118	(60)
Net revenue for the year due to the Consolidated Revenue Fund	**$ 1,935**	$ 1,656

See accompanying notes to the financial statements

EXCHANGE FUND ACCOUNT

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1999

---

1. AUTHORITY AND OBJECTIVE

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets which are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

2. SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies of the Account are set out below. As required by the *Currency Act*, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements.

a) *Valuation of assets*

The estimated fair market value of cash and short-term deposits, which are generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs including accrued interest and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and Special Drawing Rights (SDRs) include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of four major currencies (five for the comparative year).

Gold and gold loans include accrued interest. Gold and gold loans are carried in the Account at a value of 35 SDRs per fine ounce, which conforms to the value used in the *Public Accounts of Canada*.

b) *Revenue from investments*

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Write-downs of securities to their year-end market values (if applicable) are recorded as a charge to investment revenue in the year in which they occur.

c) ***Gold***

Gold sales and net gains on gold sales are recorded at settlement dates. Interest revenue from gold loans is recorded on an accrual basis and is included in revenue. Premiums received on the sales of call options on gold are recorded in revenue.

d) ***Translation of foreign currencies and SDRs***

Assets and liabilities denominated in foreign currencies and SDRs are translated into Canadian and US dollar equivalents at year-end market exchange rates, which were as follows:

	Canadian dollars	
	1999	1998
US dollar	**1.4433**	1.5333
Japanese yen	**0.01416**	0.01350
German mark	**0.7426**	0.9191
French franc	**0.2214**	0.2741
Euro	**1.4525**	-
Special Drawing Right	**1.97869**	2.1570

Foreign exchange gains or losses result from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year. Unrealized foreign exchange gains or losses on short-term currency swap arrangements with the Bank of Canada and on currency hedges are recorded in revenue as *Net foreign exchange gains (losses)*. See also Note 9.

The reported amount at year-end of assets that are hedged against exchange rate fluctuations includes unrealized gains or losses on the translation of the related outstanding hedge contracts. See also Notes 5 and 9.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

e) ***Disposition of revenues***

The revenues for the year are payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

f) ***Services received without charge***

The Account receives without charge administrative, custodial and fiscal agency services from the Bank of Canada.

g) ***Interest-free advances***

The Account receives interest-free advances from the Consolidated Revenue Fund.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar, or to meet net government requirements for foreign exchange. During the year 1999, official international reserves increased by US$ 2,744 million as a result of these operations (versus a decrease of US$ 10,467 million in 1998). None of these transactions during 1999 was aimed at moderating movements in the value of Canadian dollar (compared to the sale of US$ 9,063 million and purchase of US$ 51 million in 1998).

4. Marketable Securities Denominated in US Dollars

	1999			1998		
	(in millions of dollars)					
Securities	***Par value US***	***Amortized cost US***	***Amortized cost Canadian***	Par value US	Amortized cost US	Amortized cost Canadian
US Government	**$ 4,617**	**$ 4,736**	**$ 6,837**	$ 5,482	$ 5,645	$ 8,656
US Federal Agencies	**3,800**	**3,762**	**5,430**	1,856	1,855	2,844
Sovereign paper and International Institutions	**3,283**	**3,251**	**4,692**	1,704	1,713	2,626
Accrued interest	**-**	**203**	**292**	-	114	175
	$ 11,700	**$ 11,952**	**$ 17,251**	$ 9,042	$ 9,327	$ 14,301
Estimated market value:		**$ 11,696**	**$ 16,881**		$ 9,524	$ 14,603

Estimated market values are based on quoted market prices.

At year-end, the value of securities was written down by US$ 256 million (C$ 370 million) from their amortized cost including accrued interest, to reflect the estimated net market value of these assets. A charge of C$ 370 million was made against the investment income for 1999.

Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counter-parties in these transactions. At year-end, there were no US Government securities being used in securities lending operations, whereas for 1998 there were US$ 2,350 million (par values) of US Treasury Notes and US$ 425 million of US Treasury Bills being used in securities lending operations with financial institutions. Subsequent to year-end, the Account has resumed securities lending operations.

5. **ASSETS DENOMINATED IN OTHER FOREIGN CURRENCIES**

	Cash and Short-term Deposits			
	1999		1998	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
Euro	**$ 24**	**$ 35**	-	-
German marks	-	-	$ 252	$ 386
French francs	-	-	1	2
Japanese yen	-	-	1	1
Accrued interest	-	-	-	1
	$ 24	**$ 35**	$ 254	$ 390

	Marketable Securities			
	1999		1998	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
Euro	**$ 5,259**	**$ 7,590**	-	-
German marks	-	-	$ 2,747	$ 4,211
French francs	-	-	715	1,097
Japanese yen	**493**	**711**	246	377
Amortized cost at year-end:	**$ 5,752**	**$ 8,301**	$ 3,708	$ 5,685
Estimated market value at year-end:	**$ 5,564**	**$ 8,030**	$ 3,864	$ 5,925

Estimated market values are based on quoted market prices.

At year-end, the value of securities was written down by US$ 188 million (C$ 271 million) from their amortized cost, to reflect the estimated net market value of these assets. A charge of C$ 271 million was made against the investment income for 1999.

6. Special Drawing Rights (SDRs)

	1999		1998	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at the end of the year	**$ 526**	**$ 759**	$ 1,384	$ 2,123
Accrued interest	**3**	**5**	7	10
	$ 529	**$ 764**	$ 1,391	$ 2,133

7. Gold and Gold Loans

During the year, the Account sold 681,289 fine ounces of gold (600,000 fine ounces in 1998).

	1999		1998	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at the end of the year				
Gold loans	**$ 82**	**$ 117**	$ 117	$ 180
Gold	**5**	**8**	5	8
Accrued interest on gold loans	**1**	**2**	2	3
	$ 88	**$ 127**	$ 124	$ 191

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

		1999		1998	
		Price per fine ounce	***Total value in millions***	Price per fine ounce	Total value in millions
Carrying value	- US	**$ 47.98**	**$ 87**	$ 49.24	$ 122
	- Canadian	**69.25**	**125**	75.50	188
Market value	- US	**290.25**	**524**	287.45	715
	- Canadian	**418.92**	**756**	440.75	1,096

8. DUE TO THE CONSOLIDATED REVENUE FUND (CRF) - ADVANCES

The Account is funded by advances from the CRF. During the year, these were limited to C$ 35 billion by Order in Council dated February 21, 1997 (revised by Order in Council to C$ 40 billion effective December 30, 1999). At year-end, advances from (deposits with) the CRF consisted of:

	1999	1998
	(in millions of Canadian dollars)	
US dollars	**$ 41,686**	$ 45,951
Canadian dollars	**(19,598)**	(24,340)
German marks	-	3,676
French francs	-	1,096
Euro	**7,473**	-
Japanese yen	**708**	-
Special Drawing Rights	**(1,207)**	83
	$ 29,062	$ 26,466

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on SDR allocations to Canada are charged directly to the CRF.

Canadian dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

9. COMMITMENTS

a) *Currency swaps*

The Account enters into short-term currency swap arrangements with the Bank of Canada. The objective of these swaps is to assist the Bank in its cash management operations. As part of these agreements, the Account sells US government securities denominated in US dollars for Canadian dollars, with simultaneous agreements to repurchase these securities from the Bank on future dates at the same exchange rates in effect at the time the swaps were entered into. The maximum term of the swaps is equivalent to the term of the underlying securities; however, they are generally reversed earlier based on operational requirements of the Bank.

These swaps result in receipts of Canadian dollars by the Account, which are remitted to the Consolidated Revenue Fund. These transactions are reversed when the swaps are unwound.

At year-end, the Account had commitments to repurchase US dollar securities under swap arrangements with the Bank of Canada of US$ 3,534 million (US$ 2,941 million in 1998). The Canadian dollar equivalent at the year-end exchange rate was $5,101 million ($4,509 million in 1998).

b) ***Currency hedges and other uncompleted transactions***

At year-end, there were no commitments for forward sales and purchases of various currencies, whereas in 1998 there were commitments for net forward sales of 832 million of German marks and 35 billion of Japanese yen against total net forward purchases of US$ 774 million.

c) ***Gold options and forward contracts***

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings.

Under gold options, the Account receives a premium against commitments to sell gold at predetermined prices. No gold is sold unless the holders of the options exercise their rights by the expiry dates. At year-end, the Account had outstanding commitments to sell 50,000 fine ounces of gold under call option contracts (200,000 fine ounces in 1998) with a potential total value, if the options were exercised, of US$ 14 million (US$ 63 million in 1998). These options mature by the end of the 1st quarter in 2000.

Under forward contracts, the Account is committed to sell gold at predetermined prices on future dates. At year-end, the Account had outstanding commitments to sell 622,000 fine ounces of gold (270,000 fine ounces in 1998) for a total value of US$ 164 million (US$ 82 million in 1998). The dates of these contracts extend until August 31, 2000.

10. UNCERTAINTY DUE TO THE YEAR 2000 ISSUE

The Year-2000 computer issue arose chiefly because many date-sensitive automated systems had not been designed to recognize correctly the year 2000. This represented a significant challenge for all organizations. If not addressed properly, the Year-2000 issue could have had an impact on operations and financial reporting, ranging from minor errors to the failures of critical systems. Although the change in date has occurred, it is not possible to conclude that all aspects of the Year-2000 issue that may affect the Account, including those related to customers, suppliers, or other third parties, have been fully resolved.

ANNUAL REPORT TO PARLIAMENT ON THE OPERATIONS OF THE EXCHANGE FUND ACCOUNT BY THE MINISTER OF FINANCE AND REPORT OF THE AUDITOR GENERAL TO THE MINISTER OF FINANCE ON THE EXAMINATION OF THE ACCOUNTS AND FINANCIAL STATEMENTS OF THE EXCHANGE FUND ACCOUNT

2000

(AUSSI DISPONIBLE EN FRANÇAIS)

INTRODUCTION

This report reviews the operations of the Exchange Fund Account ("EFA") for the 2000 calendar year and the changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying Financial Statements provide additional information on the operations of the EFA.

The Exchange Fund Account is the principal repository of Canada's official international reserves. The EFA is governed by the provisions of the *Currency Act* and is held in the name of the Minister of Finance. Foreign currency borrowings by the Government of Canada are the main source of financing of the EFA.

OBJECTIVES

The objectives of the EFA are:

- to promote orderly conditions in the foreign exchange market for the Canadian dollar;
- to provide general liquidity for the government; and
- to minimize the cost of carry of the government's foreign currency liabilities used to fund the EFA's assets, with due attention to risk management.

GOVERNANCE

The Minister of Finance approves the general policies related to the management of the EFA and, in particular, establishes the target level of reserves,[1] and provides an annual report to Parliament on the operations of the Account. Responsibility for the management of the EFA is jointly shared by the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, effects transactions for the Account.

The Director, Financial Markets Division (Department of Finance) and the Chief, Financial Markets Department (Bank of Canada) are responsible for the on-going management of the EFA. A Policy Committee, comprised of senior management of the Department of Finance and the Bank of Canada, meets semi-annually to review developments, approve major policy initiatives and provide guidance and accountability on the management of the Account.

The Risk Management Unit (RMU), established by Bank of Canada to oversee the risk position of the Government of Canada, monitors and advises on the risk position of the EFA, including market, credit and liquidity risks.

KEY PRINCIPLES

In recent years the Government has increased the level of foreign exchange reserves in light of large flows in foreign exchange markets, to provide liquidity for the government's operating needs, and bring Canada more in line with other comparable sovereigns. The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis, based on many of the same principles used by private sector financial institutions, including prudent risk management principles.

---

1. See the 1996 and 1998 Budgets for statements on the government's policy to increase the level of reserves.

In this regard, interest rate and currency risks are immunized to the extent possible. On the asset side, attention is paid to asset liquidity and quality, diversification and credit limits with counterparties. On the liability side, the same attention is paid to diversified means of raising funds and a diversified investor base, as well as the cost of different sources of funds and the maturity profile of the liabilities.

Principles governing the management of the EFA include:

- There should be a sufficient amount of high-quality, highly-liquid foreign exchange reserve assets available for intervention and general liquidity purposes;
- The difference between the interest paid on the government's foreign currency liabilities used to fund EFA assets and the interest earned on those assets should be minimized (to the extent that the former is higher);
- Foreign reserves should be managed to ensure, as much as possible, that the assets match the liabilities in currency and duration;
- A prudent maturity structure and maturity profile should be maintained to limit refinancing needs;
- Best practices with regards to risk management should be applied in the overall management of the EFA;
- Credit risk should be managed prudently through diversification of the EFA asset portfolio, with appropriate use of credit ratings and counterparty limits; and,
- Foreign currency borrowing activities to fund EFA assets should be conducted so as to maintain Canada's reputation as a successful borrower in international capital markets.

Other key management guidelines include:

- The EFA portfolio is structured into a Liquidity Tier and an Investment Tier;
- At least 50% of the EFA's assets are denominated in U.S. dollars. The remainder of the portfolio is split among euro and yen-denominated assets;
- The EFA holds debt in the designated currencies of highly rated sovereign governments, their agencies and by supranational organizations having a AA-rating or better.

The Gap between Foreign Currency Assets and Liabilities

In recent years foreign currency liabilities came to exceed liquid foreign currency assets in the Exchange Fund Account, largely as a result of foreign exchange intervention and important commitments to the International Monetary Fund in 1998. At its widest point, the excess liability amounted to some US$13 billion. Consistent with the Government's policy of immunizing currency and interest rate risk in Canada's reserve program, the Government is taking steps to bring foreign currency liabilities in line with foreign currency assets.

In December 1998 the Department of Finance, in collaboration with the Bank of Canada, implemented a program of purchases of U.S. dollars in foreign exchange markets. These U.S. dollars are used to reduce U.S.-dollar denominated liabilities. Purchases of U.S. dollars are small in relation

to the large daily flows in foreign exchange markets and are undertaken with sensitivity to market conditions. This program has reduced the gap between foreign currency assets and liabilities to some US$6.5 billion, based on the market value of the assets, as of the end of December 2000, and the plan is to close it over the next few years.

Recent Developments

Collective Action Clauses

In April 2000, Canada announced that it was adopting collective action clauses in its future foreign currency bond and note issues. Collective action clauses in bond contracts facilitate debt restructuring by providing an orderly framework for debtors and creditors.

By bringing in collective action clauses, Canada indicated that it was helping to lead the process of having collective action clauses adopted by all countries. These clauses are an important part of Canada's effort to promote international financial stability and reduce the risk and severity of global financial crises. In recent years, there has been a growing consensus that the wider use of collective action clauses in international bond contracts could contribute to a more orderly resolution of financial crises.

The specific collective action clauses that Canada adopted include collective representation, majority action and non-acceleration clauses.

- Collective representation clauses facilitate restructuring discussions between issuers and bondholders.
- Majority action clauses are intended to prevent restructuring proposals from being blocked by minority bondholders.
- Non-acceleration (without majority agreement) clauses help restructuring discussions by discouraging individual bondholder action to accelerate the terms of repayment.

The documentation governing Canada's two foreign currency note programs (the Euro Medium-Term Note and Canada Note programs) has been modified to ensure that all future issuance under these programs includes collective action clauses. Future global bond issues by Canada will also include these clauses.

Risk Management

In June 2000, the Minister of Finance approved a new framework and limits governing credit exposure to commercial financial institution (FI) counterparties with respect to the government's foreign currency reserve portfolio. The framework is consistent with best practices in credit risk management, including a rigorous, comprehensive credit risk system and credit exposure limits on counterparties.

The key elements of the new framework include:

- Aggregating the government's credit exposure across all lines of EFA business (deposits, gold loans, FX forward contracts and cross-currency swaps) for each counterparty and for all FI counterparties as a group;
- Limiting the government's *actual*[2] credit exposure across all lines of EFA business and *potential* credit exposure[3] on longer-term swap (and FX forward) business per counterparty and for all FI counterparties.

The Risk Management Unit monitors actual and potential credit exposures to each of the government's FI counterparties on a daily basis and reports regularly to senior management of the Department of Finance and the Bank of Canada.

The government is also proceeding with the development of a collateral management framework to better manage the government's credit risk to FI counterparties associated with cross-currency swaps and forward contracts. Collateral management systems are increasingly the norm in capital markets as a way of managing credit risk associated with swaps. The effect of collateralization is to substitute the credit risk of the issuer of the collateral for that of the counterparty to the transaction. The government expects to have the new collateral management framework in place in 2001.

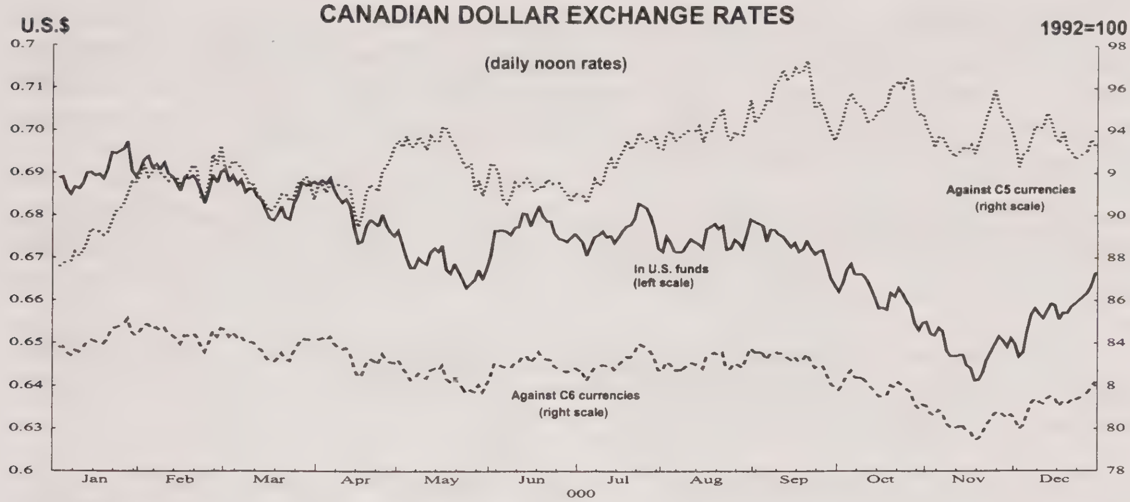
---

2. Actual credit exposure represents the loss to the government if the counterparty defaults today.
3. Potential credit exposure represents the potential loss to the government if the counterparty defaults at some time in the future.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

The Canadian dollar weakened over the year, losing almost three U.S cents (or 3.8 per cent) against the U.S. dollar, finishing the year at US$0.6669. The dollar's high for the year was US$0.6984 recorded on January 27 while the low for the year was US$0.6397 recorded on November 17. On a trade weighted basis against the C6[4] currencies the Canadian dollar depreciated by 2.6 per cent, slightly less than it declined against the U.S. dollar alone. This is explained by the fact that the Canadian dollar appreciated by over 4.8 per cent against the C5 currencies (i.e. the non-U.S. dollar C6 currencies).

CANADIAN DOLLAR EXCHANGE RATES



INTERNATIONAL FINANCIAL DEVELOPMENTS DURING 2000

The global economic climate continued to be strong in 2000. Interest rate increases by the major central banks in the first part of 2000 lowered the risk of higher inflation rates in the major industrial countries. In the second half of the year, prospects for more significant than expected economic slowdown in the United States halted the increases in interest rates seen in the first part of the year.

(1) FIRST HALF OF 2000 - STRONGER GROWTH RAISES CONCERNS ABOUT INFLATION

In Europe, economic activity improved. The euro area real GDP growth was over 3.5 per cent for the first half of the year. Among the reasons for the economic strength was firm domestic demand, coupled with the depreciation of the euro, exerting a stimulative effect on exports.

In Japan, the Bank of Japan moved away from its "zero-interest-rate policy" in August by raising its target overnight interest rate to 0.25 per cent. The reduction in monetary stimulus was motivated by a surge in output growth in the first half of 2000 led by strong business investment and buoyant demand for Japanese exports.

The U.S. economy continued to grow vigorously leading to pre-emptive interest rate increases by the Federal Reserve. The federal funds target rate increased from 5.50 per cent in January to 6.50

---

4. The C6 index includes the United States, the Euro-11, Japan, the United Kingdom, Switzerland and Sweden.

per cent in May.

The Canadian economy started 2000 on a strong note due to sustained U.S. demand. In the context of the stronger-than-expected pace of economic expansion and potential inflationary pressures, the Bank of Canada increased the Bank Rate by 25 basis points in February, 25 basis points in March and 50 basis points in May bringing the Bank's target for the overnight rate to 5.75 per cent.

(2) Second Half of 2000 - Economic conditions begin to show signs of weakness

The global economy, particularly the U.S. economy, started to show signs that growth had begun to slow more significantly and sooner than anticipated in the second part of the year. In all, past increases in interest rates, declines in personal wealth associated with weakening stock prices, and higher energy prices weakened the global economic outlook for the major industrial countries, particularly those with strong linkages to the U.S.

Prices for crude oil and natural gas increased in the later part of the year, driven by low inventories of petroleum products such as heating oil, by cold winter weather and by short-term concerns over tensions in the Middle East.

In the euro area, the pace of expansion slowed in the second half of 2000, partly owing to past increases in official rates by the European Central Bank. In addition, surveys suggested some declines in both business and household confidence.

The still fragile Japanese economy grew only marginally in the second half of the year. Household spending remained flat, reflecting weak income growth and concerns about employment prospects.

In the U.S., GDP growth slowed in response to the earlier increases in official interest rates and higher energy prices. In response, the Federal Reserve left the federal funds target rate unchanged at 6.50 per cent from May to December. At the same time, tighter credit conditions and lending standards and reduced profit margins contributed to restraining business investment.

Despite a slowing world economy and a deceleration in export growth, the pace of economic expansion in Canada remained solid in the second half of 2000, bolstered by strong domestic demand. Business investment increased considerably, reflecting further gains in profits, residential construction rose considerably, while overall consumer expenditures were supported by further increases in employment. Export volumes edged down, mainly owing to a marked slowing in the growth of U.S. demand. The Canadian economy slowed late in 2000, reflecting the further slowing in the U.S.

FINANCIAL REVIEW

1. Foreign Exchange Market Intervention

The objectives of the Exchange Fund Account are to provide general liquidity for the government and to promote orderly conditions in the foreign exchange market for the Canadian dollar. In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling foreign exchange / buying Canadian dollars when there was downward pressure on the exchange rate, or buying foreign exchange / selling Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

Since September 1998 the Bank of Canada, acting as agent for the Department of Finance, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of U.S. dollars versus the Canadian dollar (see Table 1).[5] On September 22, 2000 the Bank of Canada participated in a concerted intervention by the G7 and European central banks in support of the euro by purchasing euros by an amount equivalent to US$97 million.

Table

FOREIGN EXCHANGE MARKET INTERVENTION

	1996	1997	1998	**1999**	**2000**
	(in millions of U.S. dollars)				
Purchases	225	1,665	51	**0**	**97**[1]
Sales	-1,241	-5,326	-9,063	**0**	**0**
Net	-1,016	-3,661	-9,012	**0**	**97**

1. The intervention shown represents purchases of euros as part of Canada's participation in the G7 concerted intervention in support of the euro.

5. Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

2. Amount and Composition of Canada's Official International Reserves

The Exchange Fund Account is the principal repository of Canada's official international reserves; Canada's foreign assets at the Bank of Canada and the International Monetary Fund are also included in the total of reserves. The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2

CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31
(market value)

			Repository			
	1999 Total	**2000 Total[1]**	Exchange Fund Account	Bank of Canada	Minister of Finance	Receiver General for Canada
	(in millions of U.S. dollars)					
Convertible foreign currencies						
U.S. dollars						
Other						
Securities (Market Value)	**21,033**	**24,911**	23,931	980	-	-
Deposits (Market Value)	**3,399**	**4,108**	4,003	100	-	5
Gold	**524**	**323**	323	-	-	-
Reserve position in the IMF	**3,164**	**2,508**	-	-	2,508	-
Special drawing rights	**526**	**574**	574	-	-	-
Total holdings	**28,646**	**32,424**	28,831	1,080	2,508	5

1. The classification of assets in the Statement of Official International Reserves differs from that used in the attached financial statements.

Canada's official reserves ended the year at US$32.4 billion on a market value basis. The increase in the level of reserves over this period was funded primarily through swapped domestic issues and spot foreign exchange purchases. These financing activities are set out in greater detail in Table 7.

With regards to the Official International Reserves press release and as noted in the last Annual Report, the Government of Canada became one of the first countries in 1999 to provide enhanced reserves disclosure in a manner consistent with the standards established by the International Monetary Fund and the G-10 central banks. Initiatives to enhance international standards for reserves disclosure reflect the broad international consensus that more comprehensive and timely reserves data would help reduce the possibility of financial crises. An important feature of the enhanced reserve reporting is to provide more extensive, disaggregated data - for example, Canada reports its reserve position weekly and data related to foreign currency liabilities and off-balance sheet transactions are disclosed on a monthly basis.

Table 3 below outlines the main factors affecting the level of reserves:

Table 3

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value)

	2000 Market Value
	(millions of U.S. dollars)
Official intervention	**97**[1]
Net government operations[2]	**3,571**
Foreign currency debt including cross-currency swaps	**436**
Gains and losses on gold sales[3]	**-11**
Return on investments[4]	**2,694**
Foreign currency debt charges	**-1,841**
Foreign currency revaluation	**-1,168**
Total holdings	**3,778**

1. *Official intervention* represents purchases of euro as part of Canada's participation in the G7's concerted intervention in support of the euro currency.
2. *Net government operations* cover net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.
3. *Gains and losses on gold sales* reflects the degree to which proceeds from the sale of gold exceeds the market value of gold that existed at the end of the previous month.
4. *Return on investments* comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

More detailed information on monthly levels and changes in Canada's reserves is presented in Table 8.

3. Term Structure of EFA Investments and Liabilities

Table 4

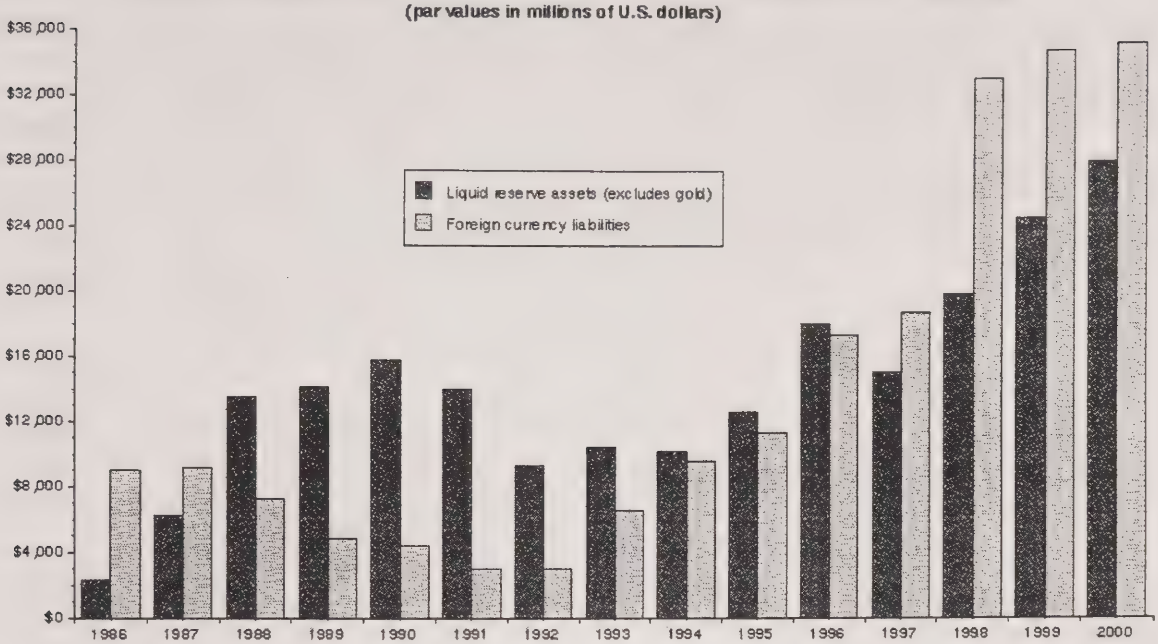
TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS AND LIABILITIES
AS AT DECEMBER 31, 2000
(par values[1] in millions of U.S. dollars)

	Foreign currency investments				
Duration	Cash and term deposits	Government securities in domestic currency	Other securities	Total assets[2]	Foreign currency liabilities
US DOLLAR HOLDINGS					
Under 6 months	3,957	823	4,703	9,483	16,305
6 to 12 months	-	429	170	599	1,000
1 to 5 years	-	2,050	5,750	7,800	7,657
Over 5 years	-	700	2,148	2,848	2,550
EURO HOLDINGS					
Under 6 months	76	-	-	76	-
6 to 12 months	-	-	-	-	-
1 to 5 years	-	1,382	418	1,800	2,069
Over 5 years	-	2,709	2,089	4,798	5,176
YEN HOLDINGS					
Under 6 months	70	-	-	70	76
Over 5 years	-	436	-	436	416
TOTAL	**4,103**	**8,529**	**15,278**	**27,910**	**35,249**

1. Data in this table reflect the par value of investments. In the attached Financial Statements, investments are reported at their book value which includes unamortized premiums or discounts where applicable and accrued interest.
2. Includes US$980 million (par value) of U.S. Government securities held temporarily by the Bank of Canada at year end, under short-terms asset swaps. See also note 10(a) to the Financial Statements that references these swaps.

As noted earlier, foreign exchange liabilities have grown significantly in recent years, particularly in 1998 due to extensive foreign exchange intervention and important commitments to the International Monetary Fund. As a result, foreign currency liabilities grew to exceed foreign currency assets in the EFA and purchases of U.S. dollars in the foreign exchange markets are being used to reduce the mismatch between foreign currency liabilities and assets. Graph 1 presents the EFA's liquid foreign reserve assets and the foreign currency liabilities since 1986.

GRAPH 1 - CANADA'S FOREIGN EXCHANGE RESERVES AND LIABILITIES, 1986-2000
(par values in millions of U.S. dollars)



4. THE EXCHANGE FUND ACCOUNT'S REVENUES

The Exchange Fund Account's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 2000, the EFA's income totalled C$2,529 million, compared with C$1,935 million in 1999. Income earned by other reserve holders is added to official reserves, but is reported directly by those other entities.

The main categories of income earned by the EFA are summarized below:

Table 5

EXCHANGE FUND ACCOUNT INCOME SUMMARY

	1996	1997	1998	1999	**2000**
	(in millions of Canadian dollars)				
INVESTMENT INCOME					
Marketable securities	961	1,030	1,364	533	**2,292**
Cash and short-term deposits	197	260	257	237	**407**
Special drawing rights	63	64	69	33	**36**
Gold	26	23	26	14	**6**
Total Investment Income	1,247	1,377	1,716	817	**2,741**
OTHER INCOME					
Gains on gold sales	156	-	253	247	**198**
Foreign exchange gains (losses)	(101)	(41)	(313)	871	**(410)**
TOTAL INCOME	1,302	1,336	1,656	1,935	**2,529**

At year end, the EFA's portfolio of marketable securities consisted entirely of discount and fixed-rate securities; there were no floating rate investments held.

The EFA's securities lending programs enhance the yield earned on its securities portfolio by lending out to counterparties securities which are highly sought after in the market. At year end, $2,825 million (par value) in U.S. Government securities were held by financial institutions that act as agents for on-lending these securities in the market. Income from securities lending was US$2.6 million in 2000.

The EFA lends gold in the market on a short term basis, periodically using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans and to establish rollover rates on these loans prior to their maturity. Income from this activity is reported as investment income on gold.

5. THE EXCHANGE FUND ACCOUNT'S COSTS

The Exchange Fund Account's cost is represented by the interest paid on Canada's foreign currency borrowings. In 2000, this cost totalled US$2,028 million. The running cost of carry of the EFA is estimated by subtracting the interest paid on Canada's foreign currency liabilities from interest earned on the EFA's assets and totalled US$28.4 in 2000. Table 6 provides an estimate of the running cost of carry for the EFA portfolio as a whole and for the euro, yen, and U.S. dollar segments of the portfolio. The cost of carry of the EFA portfolio is estimated at 8 basis points per year. The running cost of carry for the euro and the yen portfolios is lower than that of the US dollar portfolio, reflecting the comparative cost advantages which Canada has enjoyed recently in the euro and yen markets.

The Running Cost of Carry For the EFA, Year 2000[6]:

Table 6

Running Cost of Carry For the EFA

	Interest Income(US$)	Interest Paid(US$)	Net Interest	Carrying cost in basis points
	(in millions of U.S. dollars)			
Euro Portfolio	281.4	280.1	1.3	**+2**
Yen Portfolio	8.8	8.5	0.3	**+5**
US$ Portfolio				
Matched	1,305.9	1,311.2	(5.3)	**-3**
Unmatched[1]	403.1	427.8	(24.7)	**-34**
Total	1,999.2	2,027.6	(28.4)	**-8**

1. As the EFA is currently in a net foreign currency liability position, a portion of liabilities cannot be matched to any foreign currency assets. To estimate the interest income earned on the unmatched portion of the portfolio, note that sales of foreign currency assets used for intervention produce Canadian dollar cash which substitute for Canadian dollar borrowings. The cost of short-term Canadian dollar liabilities over the same period are used to estimate revenues associated with the unmatched portion of the foreign currency portfolio. The cost of carry for the unmatched U.S. dollar portfolio reflects the fact that Canadian treasury bill rates were generally lower than U.S. money market rates.

The main strategies used to reduce the cost of the EFA have been, on the liability side, to achieve cost-effective funding of the reserves and, on the asset side, to modify the composition of the Account by shifting a portion of the government's investments in sovereign issues to other higher-yielding but still liquid high quality, fixed-income securities. These securities bear returns near the rate of interest Canada pays on its foreign liabilities. To further reduce carrying costs, a more aggressive use of the government's euro-currency portfolio has been undertaken, when a comparative carrying cost advantage relative to the US-dollar assets exists. Finally, the cost of holding securities has been further reduced by proceeds derived from the government's active securities lending program.

6. ***Interest earned on assets*** includes actual and accrued interest, it does not include amortization of principal; ***Interest earned on unmatched U.S. dollar assets*** is the U.S. dollar equivalent of the year-end Canadian dollar advance to the CRF multiplied by a weighted average of Government of Canada treasury bill rates prevailing in 2000; ***Interest paid on matched U.S. dollar liabilities*** is total interest paid on U.S. dollar liabilities multiplied by the ratio of U.S. dollar assets to liabilities; The remaining interest paid is assigned to the unmatched portion of the U.S. dollar portfolio; Year-end amortized book value of assets are used to calculate net interest earned (paid) as percent of assets.

6. FINANCING OF EFA ASSETS

EFA foreign currency reserves are financed by foreign currency borrowings by the government (see Table 7). Currently, all foreign currency marketable assets are matched by foreign currency borrowings. In addition, as we noted, because of heavy intervention in support of the Canadian dollar in 1998, there are currently more foreign currency liabilities than foreign currency assets (i.e. a portion of foreign currency liabilities is not matched by foreign currency assets).

Table 7

FOREIGN CURRENCY ISSUES
AS AT DECEMBER 31
(par values)

	1998	1999	**2000**
(in millions of U.S. dollars)			
Bonds	13,217	15,038	**13,522**
Canada Bills	6,622	3,293	**3,776**
Swapped domestic issues	8,341	12,807	**14,325**
Floating Rate Note	2,000	-	**-**
Canada Notes	416	661	**638**
Euro Medium Term Notes	2,485	3,054	**2,988**
TOTAL	33,081	34,853	**35,249**

7. RISK MANAGEMENT

The government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks, related to the financing and investment of the foreign exchange reserves. The government's risk management policies call for prudent management of treasury risks based on best practices. Standards for risk tolerance are very prudent, with market risks generally immunized and high credit quality and diversification standards followed.

The governance framework separates risk management from treasury operations. The Risk Management Unit (RMU) established by the Department of Finance and the Bank of Canada monitors and advises on the risk position of the EFA. The RMU measures the EFA's major treasury risks on a daily basis and reports regularly to both treasury and senior management at the Department of Finance and the Bank of Canada.

The Risk Management Committee (RMC), meets regularly to review risk reports and to provide guidance and accountability on the government's treasury risk policies. The Committee is comprised of senior treasury management from the Department of Finance and the Bank of Canada and also includes members from the Department of Finance and the Bank of Canada outside treasury operations.

Table 8

CANADA'S OFFICIAL INTERNATIONAL RESERVES

(market value in millions of U.S. dollars)

Month End	Foreign Currencies: Securities	Foreign Currencies: Deposits	Gold[1]	Special Drawing Rights[2]	Reserve Position in the IMF[2 3]	Total	Month-to-Month Changes: Total Monthly Change	of which: Foreign Currency Debt	of which: Gains and Losses on Gold Sales	of which: Return on Investments[4]	of which: Foreign Currency Debt Charges	of which: Revaluation Effects	of which: Net Government Operations[5]	of which: Official Interven-tion
1999														
December	21,033	3,399	524	526	3,164	28,646	-251	-175	0	-42	-130	-17	113	
2000														
January	21,103	3,850	466	519	3,031	28,969	323	134	-5	-41	-105	-276	616	
February	21,715	4,149	457	534	3,032	29,887	918	464	-1	156	-157	-72	528	
March	22,886	4,223	411	537	3,050	31,107	1,220	641	-2	327	-80	-22	356	
April	21,857	5,048	387	526	2,616	30,434	-673	-241	-1	-98	-87	-342	96	
May	21,738	4,224	364	545	2,612	29,483	-951	-1,037	-1	318	-222	-148	139	
June	22,483	4,120	358	553	2,646	30,160	677	-121	-1	409	-170	0	560	
July	22,675	4,143	344	543	2,517	30,222	62	-174	0	296	-211	-372	523	
August	22,741	4,615	328	557	2,337	30,578	356	-20	0	165	-106	-239	556	
September	22,923	4,571	324	554	2,325	30,697	119	-263	0	239	-174	-64	-284	97
October	23,105	4,288	313	546	2,292	30,544	-153	108	0	150	-89	-264	-58	
November	23,362	4,575	319	565	2,256	31,077	533	290	0	361	-254	153	-17	
December	24,911	4,108	323	574	2,508	32,424	1,347	655	0	412	-186	478	-12	

1. Gold valuation is based on the London p.m. fix on the last business day of the reporting month.
2. SDR-denominated assets are valued in U.S. dollar at the SDR rate established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
3. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.
4. Return on investments is comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates.
5. Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

EXCHANGE FUND ACCOUNT

FINANCIAL STATEMENTS

DECEMBER 31, 2000

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of his audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

David A. Dodge
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

F.J. Mahoney
Chief Accountant
Bank of Canada

AUDITOR GENERAL OF CANADA

VÉRIFICATEUR GÉNÉRAL DU CANADA

AUDITOR'S REPORT

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 2000 and the statement of revenue for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 2000 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

John Wiersema, CA

Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 16, 2001

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 2000

	2000		1999	
	(in millions of dollars)			
	US	Canadian	US	Canadian
ASSETS				
Denominated in US dollars				
Cash and short-term deposits	$ 4,240	$ 6,358	$ 3,575	$ 5,160
Marketable securities (Note 5)	16,089	24,126	11,696	16,881
	20,329	30,484	15,271	22,041
Denominated in other foreign currencies				
Cash and short-term deposits (Note 6)	146	219	24	35
Marketable securities (Note 6)	7,167	10,747	5,564	8,030
	7,313	10,966	5,588	8,065
Denominated in Special Drawing Rights				
Special Drawing Rights (Note 7)	579	868	529	764
Gold and gold loans (Note 8)	54	81	88	127
	633	949	617	891
Official international reserve assets	$ 28,275	$ 42,399	$ 21,476	$ 30,997

DUE TO THE CONSOLIDATED REVENUE FUND

	2000 Canadian	1999 Canadian
Advances (Note 9)	$ 39,870	$ 29,062
Net revenue for the year	2,529	1,935
	$ 42,399	$ 30,997

Approved:

David A. Dodge
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

F.J. Mahoney
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

EXCHANGE FUND ACCOUNT
STATEMENT OF REVENUE

FOR THE YEAR ENDED DECEMBER 31, 2000

	2000	1999
	(in millions of Canadian dollars)	
Revenue from investments		
Marketable securities	**$ 2,292**	$ 533
Cash and short-term deposits	**407**	237
Special Drawing Rights	**36**	33
Gold	**6**	14
	2,741	817
Other revenue (loss)		
Gain on sales of gold	**198**	247
Net foreign exchange gains/(losses)	**(410)**	871
	(212)	1,118
Net revenue for the year due to the Consolidated Revenue Fund	**$ 2,529**	$ 1,935

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to Financial Statements
December 31, 2000

---

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets which are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

2. Significant Accounting Policies

Significant accounting policies of the Account are set out below. As required by the *Currency Act*, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements.

a) *Valuation of assets*

The estimated fair market value of cash and short-term deposits, which are recorded at cost and generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs including accrued interest and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and Special Drawing Rights (SDR) include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of four major currencies.

Gold and gold loans include accrued interest. Gold and gold loans are carried in the Account at a value of 35 SDR per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*.

b) *Revenue from investments*

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Write downs of securities to their year-end market values (if applicable) are recorded as a charge to investment revenue in the year in which they occur.

c) ***Gold***

Gold sales and net gains on gold sales are recorded at settlement dates. Interest revenue from gold loans is recorded on an accrual basis and is included in revenue. Premiums received on the sales of call options on gold are recorded in revenue.

d) ***Translation of foreign currencies and SDRs***

Assets and liabilities denominated in foreign currencies and SDRs are translated into Canadian and US dollar equivalents at year-end market exchange rates, which were as follows:

	Canadian dollars	
	2000	1999
US dollar	**1.4995**	1.4433
Euro	**1.4086**	1.4525
Japanese yen	**0.01307**	0.01416
Special Drawing Rights	**1.95371**	1.97869

Foreign exchange gains or losses result from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year. Unrealized foreign exchange gains or losses on short-term currency swap arrangements with the Bank of Canada and on currency hedges are recorded in revenue as *Net foreign exchange gains (losses)*. See also Note 10.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

e) ***Disposition of revenue***

Revenue for the year is payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the *Currency Act.*

f) ***Services received without charge***

The Account receives without charge administrative, custodial and fiscal agency services from the Bank of Canada. Costs related to these services are not recognized in the financial statements.

g) ***Interest-free advances***

The Account receives interest-free advances from the Consolidated Revenue Fund. Interest cost related to these advances is not recognized in the financial statements.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar, or to meet net government requirements for foreign exchange. During the year 2000, official international reserves increased by US$ 3,778 million as a result of these operations (an increase of US$ 2,744 million in 1999). None of these transactions during 2000 and 1999 was aimed at moderating movements in the value of the Canadian dollar.

4. Risk Management and Financial Instruments

The role of the EFA as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the EFA asset portfolio is prudently diversified with respect to credit risk, the investment guidelines specify limits on holdings by class of issuer (sovereign, agency, supranational or commercial financial institution) and type of instrument, while there are further limits on exposure to any one issuer or counter-party.

Interest rate and foreign currency risks are minimized by matching the duration structure and the currency of the EFA's assets and the related foreign currency borrowings of the government of Canada.

5. Marketable Securities Denominated in US Dollars

	2000			1999		
	(in millions of dollars)					
Securities	*Par value*	*Amortized cost*		Par value	Amortized cost	
	US	*US*	*Canadian*	US	US	Canadian
US Government	**$ 3,022**	**$ 3,046**	**$ 4,567**	$ 4,617	$ 4,736	$ 6,837
US Federal Agencies	**4,655**	**4,611**	**6,915**	3,800	3,762	5,430
Sovereign paper and International Institutions	**8,244**	**8,146**	**12,214**	3,283	3,251	4,692
Accrued interest	**-**	**286**	**430**	-	203	292
	$ 15,921	**$ 16,089**	**$ 24,126**	$ 11,700	$ 11,952	$ 17,251
Estimated market value at year-end:		**$ 16,319**	**$ 24,471**		$ 11,696	$ 16,881

Estimated market values are based on quoted market prices.

At year-end, the value of securities was not written down (versus a write down of US $ 256 million or C$ 370 million from their amortized cost in 1999).

Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counter-parties in these transactions. At year-end, a portion of the Account's holdings of US Government securities consisting of US $ 2,825 million (par value) in Treasury Notes (nil in 1999) was being used in securities lending operations with financial institutions.

6. Assets Denominated in Other Foreign Currencies

Cash and Short-term Deposits (in millions of dollars)

	2000 US	2000 Canadian	1999 US	1999 Canadian
Euro	$ 76	$ 114	$ 24	$ 35
Japanese yen	70	105	-	-
	$ 146	$ 219	$ 24	$ 35

Marketable Securities (in millions of dollars)

	2000 US	2000 Canadian	1999 US	1999 Canadian
Euro	$ 6,729	$ 10,091	$ 5,259	$ 7,590
Japanese Government	438	656	493	711
Amortized cost at year-end:	$ 7,167	$ 10,747	$ 5,752	$ 8,301
Estimated market value at year-end:	$ 7,174	$ 10,757	$ 5,564	$ 8,030

Estimated market values are based on quoted market prices.

At year-end, the value of securities was not written down (versus a write down of US $ 188 million or C$ 271 million from their amortized cost in 1999).

7. Special Drawing Rights (SDR)

(in millions of dollars)

	2000 US	2000 Canadian	1999 US	1999 Canadian
Held at year-end	$ 574	$ 861	$ 526	$ 759
Accrued interest	5	7	3	5
	$ 579	$ 868	$ 529	$ 764

8. Gold and Gold Loans

During the year, the Account sold 621,745 fine ounces of gold (681,289 fine ounces in 1999).

	2000		1999	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at year-end				
Gold loans	**$ 49**	**$ 74**	$ 82	$ 117
Gold	**5**	**7**	5	8
Accrued interest on gold loans	**-**	**-**	1	2
	$ 54	**$ 81**	$ 88	$ 127

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

		2000		1999	
		Price per fine ounce	***Total value in millions***	Price per fine ounce	Total value in millions
Carrying value	- US	**$ 45.60**	**$ 54**	$ 47.98	$ 87
	- Canadian	**68.38**	**81**	69.25	125
Market value	- US	**272.65**	**323**	290.25	524
	- Canadian	**408.84**	**484**	418.92	756

9. Due to the Consolidated Revenue Fund (CRF) - Advances

The Account is funded by advances from the CRF. These were limited to C$ 40 billion by Order in Council dated December 30, 1999. On March 2, 2000, the Order in Council was revised to read "the aggregate amount of advances outstanding as of December 31 of each calendar year shall not exceed $50,000,000,000". At year-end, advances from (deposits with) the CRF consisted of:

	2000	1999
	(in millions of Canadian dollars)	
US dollars	**$ 41,242**	$ 41,686
Canadian dollars	**(10,798)**	(19,598)
Euro	**9,860**	7,473
Japanese yen	**758**	708
Special Drawing Rights	**(1,192)**	(1,207)
	$ 39,870	$ 29,062

The proceeds of Canada's borrowings in foreign currencies and allocations of SDR by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on SDR allocations to Canada are charged directly to the CRF.

Canadian dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

10. Commitments

a) *Currency swaps*

The Account enters into short-term currency swap arrangements with the Bank of Canada. The objective of these swaps is to assist the Bank in its cash management operations. The Account sells US dollars for Canadian dollars, with simultaneous agreements to repurchase these US dollars from the Bank on future dates at the same exchange rates in effect at the time the swaps were entered into. The maximum term of the swaps is equivalent to the term of the underlying securities; however, they are generally reversed earlier based on operational requirements of the Bank.

These swaps result in receipts of Canadian dollars by the Account, which are remitted to the Consolidated Revenue Fund. These transactions are reversed when the swaps are unwound.

At year-end, the Account had commitments to repurchase US dollars under swap arrangements with the Bank of Canada of US $ 1,004 million (US $ 3,534 million in 1999). The Canadian dollar equivalent at the year-end exchange rate was $ 1,506 million ($5,101 million in 1999).

b) Gold options and forward contracts

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings.

Under gold options, the Account receives a premium against commitments to sell gold at predetermined prices. No gold is sold unless the holders of the options exercise their rights by the expiry dates. At year-end, the Account had no outstanding commitments to sell gold (50,000 fine ounces of gold under call option contracts with a potential total value of US$ 14 million in 1999).

Under forward contracts, the Account is committed to sell gold at predetermined prices on future dates. At year-end, the Account had outstanding commitments to sell 20,000 fine ounces of gold (622,000 fine ounces of gold in 1999) for a total value of US$ 6 million (US$ 164 million in 1999). The value date of these contracts is February 23, 2001.

ANNUAL REPORT TO PARLIAMENT ON THE OPERATIONS OF THE EXCHANGE FUND ACCOUNT BY THE MINISTER OF FINANCE

AND

REPORT OF THE AUDITOR GENERAL TO THE MINISTER OF FINANCE ON THE EXAMINATION OF THE ACCOUNTS AND FINANCIAL STATEMENTS OF THE EXCHANGE FUND ACCOUNT

2001

(AUSSI DISPONIBLE EN FRANÇAIS)

INTRODUCTION

This report reviews the operations of the Exchange Fund Account ("EFA") for the 2001 calendar year and the changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying Financial Statements provide additional information on the operations of the EFA.

The Exchange Fund Account is the principal repository of Canada's official international reserves. The EFA is governed by the provisions of the *Currency Act* and is held in the name of the Minister of Finance. Foreign currency borrowings by the Government of Canada are the main source of financing of the EFA.

Objectives

The objectives of the EFA are:

- to provide general foreign-currency liquidity for the government; and
- to provide funds to help promote orderly conditions in the Canadian dollar in the foreign exchange market.

Governance

The government approves the general policies related to the management of the EFA and, in particular, establishes the target level of reserves, and provides an annual report to Parliament on the operations of the Account. Responsibility for the management of the EFA is jointly shared by the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the government, effects transactions for the Account.

The Director, Financial Markets Division (Department of Finance) and the Chief, Financial Markets Department (Bank of Canada) are responsible for the on-going management of the EFA. A Policy Committee, comprised of senior management of the Department of Finance and the Bank of Canada, meets semi-annually to review developments, approve major policy initiatives and provide guidance and accountability on the management of the Account.

The Risk Management Unit (RMU), established by the Bank of Canada to oversee the risk position of the Government of Canada, monitors and advises on the risk position of the EFA, including market, credit and liquidity risks.

Key Principles

In recent years the Government has increased the level of foreign exchange reserves in light of large flows in foreign exchange markets, to provide liquidity for the government's operating needs in foreign currencies, and bring Canada more in line with other comparable sovereigns.[1] The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis, based on many of the same principles used by private sector financial institutions, including prudent risk management principles.

In this regard, interest rate and currency risks are immunized to the extent possible. On the asset side, attention is paid to asset liquidity and quality, diversification and credit limits with counterparties. On the liability side, the same attention is paid to diversified means of raising funds and a diversified investor base, as well as to the cost of different sources of funds and the maturity profile of the liabilities.

Principles governing the management of the EFA include;

- There should be a sufficient amount of high-quality, highly-liquid foreign exchange reserve assets available for general liquidity purposes and possible intervention in the foreign exchange market to promote orderly conditions in the Canadian dollar;
- The difference between the interest paid on the government's foreign currency liabilities used to fund EFA assets and the interest earned on those assets should be minimized (to the extent that the former is higher);
- Foreign reserves should be managed to ensure, as much as possible, that the assets match the liabilities in currency and duration;
- A prudent maturity structure and maturity profile should be maintained to limit refinancing needs within the context of liquidity requirements;
- Best practices with regards to risk management should be applied in the overall management of the EFA;
- Credit risk should be managed prudently through diversification of the EFA asset portfolio, with appropriate use of credit ratings, counterparty limits and collateral support; and
- Foreign currency borrowing activities (e.g. Global bonds and medium term notes) to fund EFA assets should be conducted so as to maintain Canada's reputation as a successful borrower in international capital markets.

Other key management guidelines include;

- The EFA portfolio is structured into a Liquidity Tier and an Investment Tier;
- At least 50% of the EFA's assets are to be denominated in U.S. dollars. The remainder of the portfolio is to be split among euro and yen-denominated assets;
- The EFA holds debt in the designated currencies of highly rated sovereign governments, their agencies and by supranational organizations having a AA-rating or better.

---

1. See the 1996 and 1998 Budgets for statements on the government's policy to increase the level of reserves.

The Gap between Foreign Currency Assets and Liabilities

In recent years foreign currency liabilities came to exceed liquid foreign currency assets in the Exchange Fund Account, largely as a result of foreign exchange intervention and important commitments to the International Monetary Fund in 1998. At its widest point, the excess liability amounted to some US$13 billion. Consistent with the Government's policy of immunizing currency and interest rate risk in Canada's reserve program, the Government is taking steps to bring foreign currency liabilities in line with foreign currency assets.

In December 1998 the Department of Finance, in collaboration with the Bank of Canada, implemented a program of purchases of U.S. dollars in foreign exchange markets. These U.S.-dollar purchases are small in relation to the large daily flows in foreign exchange markets and are undertaken with sensitivity to market conditions. This program has reduced the gap between foreign currency assets and liabilities to some US$4.8 billion, based on the market value of the assets, as of the end of December 2001, and the plan is to eliminate the gap over the next few years.

Recent Developments

The Risk Management Unit monitors credit exposures to each of the government's financial institution (FI) counterparties on a daily basis and reports regularly on counterparties' credit positions to senior management of the Department of Finance and the Bank of Canada. Consistent with best practices in risk management in recent years, the government has been moving to a broad collateral management approach in its fund management operations to better manage its credit risk to FI counterparties. Collateral management systems[2] are increasingly the norm in capital markets as a way of managing credit risk. The effect of collateralization is to substitute the credit risk of the issuer of the collateral for that of the counterparty to the transaction.

Collateral frameworks are being implemented on both the domestic and foreign sides of the government's treasury operations. The government is in the process of implementing a new credit framework for the investment of its domestic (Receiver General) cash balances which will include a move from uncollateralized to partially collateralized investment of the cash. On the foreign side, the government is putting in place a collateral framework for its cross-currency swap program used to raise foreign exchange reserves. The collateral framework for swaps will be operational in the spring of 2002.

The government will also be moving in the next year from uncollateralized short-term US-dollar deposits to collateralized repos to manage credit risk associated with that line of business. Currently, the government invests its US-dollar cash balances in unsecured bank deposits with a number of commercial banks. In line with the evolution of best practices, the government has decided to reduce its credit exposure to FIs through the introduction of a repo program. Under this framework, collateral would be posted to the government when US-dollar cash is invested with the government's FI counterparties.

Coincident with the implementation of collateral management frameworks for the government's cross-currency swap and US-dollar deposit programs, the government will be modifying

---

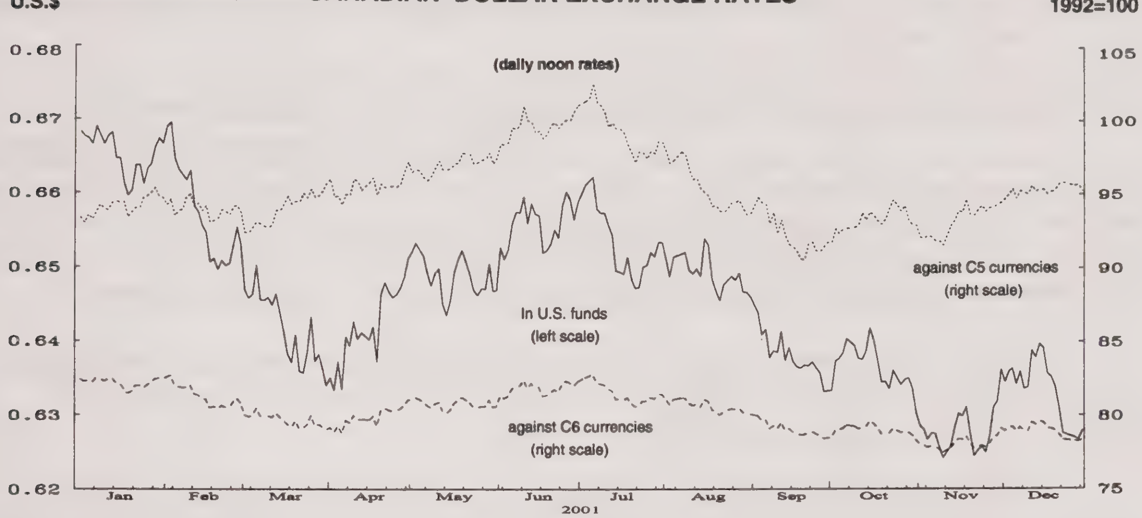
2. Collateral management systems involve the pledging of collateral (e.g. securities, cash) by a counterparty to another, in order to reduce the credit risk faced by the latter, should the former default.

its credit guidelines to accept a modest amount of A-rated FI US dollar exposure. This change will help the government further diversify its credit risk across FI counterparties and will help improve further the cost of carry of the reserve portfolio. Credit exposure to A-rated FIs will be contained within prudent standards, consistent with best practices of comparable sovereigns and market participants.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

The Canadian dollar depreciated relative to the U.S. dollar over the year, losing almost four U.S cents (or 6.2 per cent) against the U.S. dollar, finishing the year at US$0.6278. The dollar's high for the year was US$0.6711 recorded on February 2nd while the low for the year was US$0.6230 recorded on November 9th. On a trade weighted basis against the C6[3] currencies the Canadian dollar depreciated by 4.7 per cent, less than it declined against the U.S. dollar alone. This is explained by the fact that the Canadian dollar appreciated by almost 2.1 per cent against the C5 currencies (i.e. the non-U.S. dollar C6 currencies).

CANADIAN DOLLAR EXCHANGE RATES



INTERNATIONAL FINANCIAL DEVELOPMENTS DURING 2001

The global economic climate slowed in the first half of 2001. The short-term disruptions created by the terrorist attacks on September 11th led to negative growth in the third quarter. Following the attacks, central banks worldwide moved quickly to provide liquidity support to the global financial system.

(1) FIRST HALF OF 2001 - A GLOBAL SLOWDOWN

In Europe, the spillover effects from the U.S. slowdown in investment spending, along with the effects of weaker domestic demand, were already being increasingly felt prior to the attacks in September. European industrial production growth slowed in the first quarter of 2001 and the unemployment rate was at 8.3% in May.

In Japan, the economy deteriorated further from the previous year. Exports continued to decline and industrial output slumped. As for market indicators, stock prices, which had been rising until early May, started falling afterwards. Long-term interest rates started to ease in early August reflecting concerns about the deterioration in the economy.

---

3. The C6 index includes the United States, the Euro-11, Japan, the United Kingdom, Switzerland and Sweden.

Economic growth in the United States slowed during the first half of 2001. To an important extent, this deceleration reflected the sharp turnaround in the growth of investment spending (which had been a key element in the U.S. expansion). Investment in the technology sector was hit particularly hard. Industrial production also fell as firms strove to bring stock levels into line with demand. At the same time, consumer spending and housing expenditures continued to advance, albeit at a slower pace. Although some slowing to a more sustainable pace had been desirable, the slowdown was deeper and more prolonged than initially expected.

By midsummer, evidence began to accumulate that the Canadian economic slowdown would be deeper and more protracted than previously anticipated. Core inflation rose above 2 per cent in the spring and hovered around 2.3 per cent through the summer months. In contrast, because of declining energy prices, total CPI inflation had fallen sharply from a peak rate of nearly 4 per cent in the spring and was moving down towards core inflation.

(2) Second Half of 2001 - Continued uncertainty about economic prospects

During the summer, fading hopes for economic recovery had already weakened the major stock markets and problems in emerging markets had resurfaced. There were declines in most categories of international financial flows in the second quarter and at the start of the third, as borrowers moved to trim investment plans and restore balance sheets. The attacks shook consumers and business confidence still further and reinforced prospects for a broad global slowdown.

In the euro area, the spillover effects to domestic demand from geopolitical uncertainties and the U.S. slowdown apparently dampened economic growth by more than anticipated. The unemployment rate was at 8.5% by the end of the year.

In Japan, economic problems continued unabated throughout last year, largely because efforts to revive the economy were constrained by underlying structural difficulties, including ongoing problems in the financial sector, as well as deteriorating business and household confidence.

By year-end, the geopolitical situation in the United States improved and the global economy started to recover. Consumer confidence rebounded from the lows reached after the terrorist attacks. However, business investment remained weak, reflecting low corporate profits and uncertainty about growth prospects.

Canada's economic conditions weakened further as a result of the terrorist attacks in the United States. Growth became negative in the third quarter, reflecting weakening in both domestic and foreign demand. However, a rebound in consumer confidence together with lower taxes and much lower interest rates, led to a rebound in economic activity in the fourth quarter.

FINANCIAL REVIEW

1. Foreign Exchange Market Intervention

The objectives of the Exchange Fund Account are to provide general foreign currency liquidity for the government and to provide funds to help promote orderly conditions in the Canadian dollar in the foreign exchange market. In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in an automatic fashion (selling foreign exchange / buying Canadian dollars when there was downward pressure on the exchange rate, or buying foreign exchange / selling Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, current government policy is for the Bank of Canada to intervene on a discretionary basis.

Since September 1998 the Bank of Canada, acting as agent for the government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of U.S. dollars versus the Canadian dollar (see Table 1).[4]

Table 1

FOREIGN EXCHANGE MARKET INTERVENTION

	1997	1998	1999	2000	2001
	(in millions of U.S. dollars)				
Purchases	1,665	51	0	97[1]	0
Sales	-5,326	-9,063	0	0	0
Net	-3,661	-9,012	0	97	0

1. The intervention shown represents purchases of euros as part of Canada's participation in the G7 concerted intervention in support of the euro.

4. Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

2. Amount and Composition of Canada's Official International Reserves

The Exchange Fund Account is the principal repository of Canada's official international reserves; Canada's foreign assets at the Bank of Canada and the International Monetary Fund are also included in the total of reserves. The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2

CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31
(market value)

			Repository			
	2000 Total	**2001 Total**[1]	Exchange Fund Account	Bank of Canada	Minister of Finance	Receiver General for Canada
	(in millions of U.S. dollars)					
Convertible foreign currencies						
Securities	24,911	**26,329**	26,329	-	-	-
Deposits	4,108	**4,155**	4,051	100	-	4
Gold	323	**291**	291	-	-	-
Reserve position in the IMF	2,508	**2,859**	-	-	2,859	-
Special drawing rights	574	**614**	614	-	-	-
Total	32,424	**34,248**	31,285	100	2,859	4

1. The classification of assets in the Statement of Official International Reserves differs from that used in the attached financial statements.

Canada's official reserves ended the year at US$34.2 billion on a market value basis. The increase in the level of reserves over this period was funded primarily through swapped domestic issues. These financing activities are set out in greater detail in Table 7.

Table 3 below outlines the main factors affecting the level of reserves:

Table 3

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES

(market value)

	2001 Market Value
	(millions of U.S. dollars)
Official intervention	0
Net government operations[1]	1,723
Foreign currency debt	-2,225
Cross-currency swaps	2,285
Gains and losses on gold sales[2]	1
Return on investments[3]	1,943
Foreign currency debt charges	-1,683
Foreign currency revaluation	-543
Other transactions[4]	323
Total change	1,824

1. *Net government operations* cover net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.
2. *Gains and losses on gold sales* reflect the degree to which proceeds from the sale of gold exceeds the market value of gold that existed at the end of the previous month.
3. *Return on investments* comprises interest earned on investments and changes in the market value of securities.
4. *Other transactions* covers increased support for IMF lending operations.

More detailed information on monthly levels and changes in Canada's reserves is presented in Table 8.

3. Term Structure of EFA Investments and Liabilities

Table 4

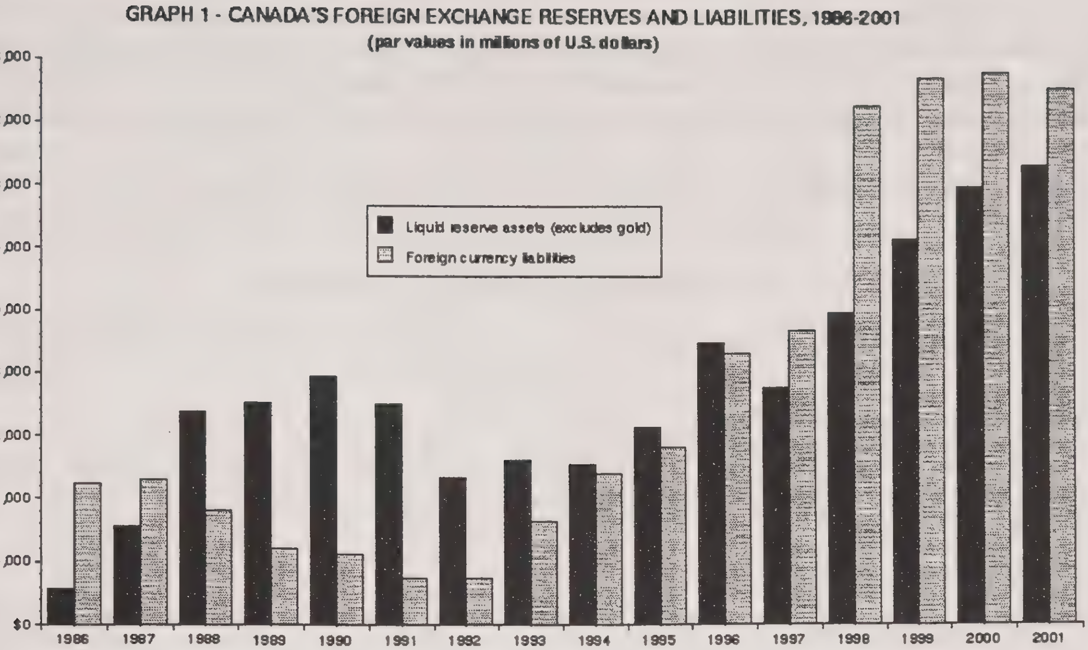
TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS AND LIABILITIES AS AT DECEMBER 31, 2001

(par values[1] in millions of U.S. dollars)

Term	Foreign currency investments: Cash and term deposits	Government securities in domestic currency	Other securities	Total assets	Foreign currency liabilities[2],
US DOLLAR HOLDINGS					
Under 6 months	4,066	3,200	2,330	9,596	14,829
6 to 12 months	-	50	578	628	250
1 to 5 years	-	-	6,912	6,912	7,250
Over 5 years	-	-	1,848	1,848	1,550
EURO HOLDINGS[3]					
Under 6 months	45	-	-	45	-
6 to 12 months	-	-	214	214	303
1 to 5 years	-	-	2,761	2,761	2,899
Over 5 years	-	-	6,515	6,515	6,270
YEN HOLDINGS					
Under 6 months	61	-	-	61	61
1 to 5 years		380		380	380
Over 5 years	-	380	-	380	380
TOTAL	**4,172**	**4,010**	**21,158**	**29,340**	**34,172**

1. Data in this table reflect the par value of all investments and liabilities. In the attached Financial Statements, investments are reported at their book value which includes unamortized premiums or discounts where applicable and accrued interest.
2. The December 31, 2001 exchange rate was used for the euro and yen assets and liabilities.
3. The liability data fully reflect the impact of the government's long-term interest rate and currency swaps. For example, $4,049 million of the $9,472 million Euro liabilities consist of swapped domestic issues.

As noted earlier, foreign exchange liabilities have grown significantly in recent years, particularly in 1998 due to extensive foreign exchange intervention and important commitments to the International Monetary Fund. As a result, foreign currency liabilities grew to exceed foreign currency assets in the EFA and purchases of U.S. dollars in the foreign exchange markets are being used to reduce the mismatch between foreign currency liabilities and assets. Graph 1 presents the EFA's liquid foreign reserve assets and the foreign currency liabilities since 1986.


GRAPH 1 - CANADA'S FOREIGN EXCHANGE RESERVES AND LIABILITIES, 1986-2001
(par values in millions of U.S. dollars)
Liquid reserve assets (excludes gold)
Foreign currency liabilities
$36,000
$32,000
$28,000
$24,000
$20,000
$16,000
$12,000
$8,000
$4,000
$0
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001

4. THE EXCHANGE FUND ACCOUNT'S REVENUES

The Exchange Fund Account's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 2001, the EFA's income totalled C$2,258 million, compared with C$2,529 million in 2000. Income earned by other reserve holders is added to official reserves, but is reported directly by those other entities.

The main categories of income earned by the EFA are summarized below:

Table 5

EXCHANGE FUND ACCOUNT INCOME SUMMARY

	1997	1998	1999	2000	**2001**
	(in millions of Canadian dollars)				
INVESTMENT INCOME					
Marketable securities	1,030	1,364	533	2,292	**2,318**
Cash and short-term deposits	260	257	237	407	**303**
Special drawing rights	64	69	33	36	**32**
Gold	23	26	14	6	**7**
Total Investment Income	1,377	1,716	817	2,741	**2,660**
OTHER INCOME					
Gains on gold sales	-	253	247	198	**50**
Foreign exchange gains (losses)	(41)	(313)	871	(410)	**(452)**
TOTAL INCOME	1,336	1,656	1,935	2,529	**2,258**

At year end, the EFA's portfolio of marketable securities consisted entirely of discount and fixed-rate securities; there were no floating rate investments held.

The EFA's securities lending programs enhance the yield earned on its securities portfolio by lending out to counterparties securities which are highly sought after in the market. At year end, $2,500 million (par value) in U.S. Government securities were held by financial institutions that act as agents for on-lending these securities in the market. Income from securities lending was US$1.5 million in 2001.

The EFA lends gold in the market on a short term basis, periodically using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans and to establish rollover rates on these loans prior to their maturity. Income from this activity is reported as investment income on gold.

5. THE EXCHANGE FUND ACCOUNT'S CARRY

The Exchange Fund Account's carry is estimated by subtracting the interest paid on Canada's foreign currency liabilities from interest earned on the EFA's assets (i.e. the net interest earned or paid). In 2001, the net interest earned totalled US$21.7 million. Table 6 provides an estimate of the carry for the EFA portfolio as a whole and for the euro, yen, and U.S. dollar segments of the portfolio. The carry of the total EFA portfolio in 2001 is estimated at 6 basis points. On an individual portfolio basis, the carry for the euro portfolio is higher than that of the US dollar and yen portfolios, reflecting the comparative funding and investment opportunities in the euro market.

Carry for the EFA, Year 2001[5]:

Table 6

Carry for the EFA

	Interest Earned on Assets	Interest Paid on Liabilities	Net Interest Earned on Assets	Carry in basis points
	(in millions of U.S. dollars)			
Euro Portfolio	389.2	371.6	17.6	+22
Yen Portfolio	9.7	9.7	-	-
US$ Portfolio				
Matched	1,113.3	1,105.7	7.6	+4
Unmatched[1]	192.2	195.7	(3.5)	-7
Total	1,704.4	1,682.7	21.7	+6

1. As the EFA is currently in a net foreign currency liability position, a portion of liabilities cannot be matched to any foreign currency assets. To estimate the interest income earned on the unmatched portion of the portfolio, note that sales of foreign currency assets in intervention produce Canadian dollar cash which substitute for Canadian dollar borrowings. The interest paid on short-term Canadian-dollar liabilities over the same period are used to estimate the interest earned on the unmatched portion of the US-dollar portfolio.

The main strategies used to enhance the carry of the EFA have been, on the liability side, to achieve cost-effective funding of the reserves and, on the asset side, to modify the composition of the Account by shifting a portion of the government's investments in sovereign issues to other higher-yielding but still liquid high-quality, fixed-income securities. These securities bear returns near the rate of interest Canada pays on its foreign liabilities. To further enhance carry, a more aggressive use of the government's euro-currency portfolio has been undertaken, when a comparative funding and investment advantage relative to the US-dollar assets exists. Finally, the EFA's carry has been further enhanced by proceeds derived from the government's active securities lending program.

5. ***Interest earned on the euro, yen, and U.S. dollar matched portfolios*** includes actual and accrued interest and amortization of premium/discount. ***Interest earned on the unmatched U.S. dollar portfolio*** is the U.S. dollar equivalent of the Canadian dollar advance to the CRF multiplied by a weighted average of Government of Canada treasury bill rates prevailing in 2001. ***Interest paid on liabilities*** includes actual and accrued interest but does not include a relatively small amount of amortization.

6. Financing of EFA Assets

EFA foreign currency reserves are financed by foreign currency borrowings by the government (see Table 7). Currently, all foreign currency marketable assets are matched by foreign currency borrowings. In addition, as noted before, because of heavy intervention in support of the Canadian dollar in 1998, there are currently more foreign currency liabilities than foreign currency assets (i.e. a portion of foreign currency liabilities is not matched by foreign currency assets).

Table 7

FOREIGN CURRENCY ISSUES AS AT DECEMBER 31
(par values)[1]

	1999	2000	**2001**
(in millions of U.S. dollars)			
Bonds	15,038	13,522	**12,555**
Canada Bills	3,293	3,776	**2,686**
Swapped domestic issues	12,807	14,325	**16,608**
Floating Rate Note	-	-	**-**
Canada Notes	661	638	**928**
Euro Medium Term Notes	3,054	2,988	**2,571**
TOTAL	34,853	35,249	**35,348**

1. Liabilities are stated at historical FX rates.

7. Risk Management

The government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks, related to the financing and investment of the foreign exchange reserves.[6] The government's risk management policies call for prudent management of treasury risks based on best practices. Standards for risk tolerance are very prudent, with market risks generally immunized and high credit quality and diversification standards followed.

The governance framework separates risk management from treasury operations. The Risk Management Unit (RMU) established by the Department of Finance and the Bank of Canada monitors and advises on the risk position of the EFA. The RMU measures the EFA's major treasury risks on a daily basis and reports regularly to both treasury and senior management at the Department of Finance and the Bank of Canada.

The Risk Management Committee (RMC) meets regularly to review risk reports and to provide guidance and accountability on the government's treasury risk policies. The Committee is comprised of senior treasury management from the Department of Finance and the Bank of Canada and also includes members from the Department of Finance and the Bank of Canada outside treasury operations.

---

6. For more information on the government's risk management framework, see article published in the winter 2001-02 edition of the Bank of Canada Review.

Table 8

CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value in millions of U.S. dollars)

Month-to-Month Changes

Month End	Securities	Deposits	Gold[1]	Special Drawing Rights[2]	Reserve Position in the IMF[2 3]	Total	Total Monthly Change	Foreign Currency Debt	Gains and Losses on Gold Sales	Return on Invest-ments[4]	Foreign Cur-rency Debt Charges	Revalua-tion Effects	Net Govern-ment Opera-tions[5]	Offi-cial Inter-ven-tion	Other transac-tions[6]
2000															
December	24,911	4,108	323	574	2,508	32,424	1,347	655	0	412	-186	478	-12	0	0
2001															
January	24,291	5,081	313	572	2,581	32,838	414	226	0	251	-140	-49	126	0	0
February	24,548	5,002	310	587	2,464	32,911	73	-28	1	151	-121	-111	181	0	0
March	25,314	4,923	300	573	2,403	33,513	602	1,082	0	227	-177	-469	-61	0	0
April	25,096	4,862	306	575	2,368	33,207	-306	-149	0	-81	-92	109	-93	0	0
May	24,834	5,122	311	586	2,408	33,261	54	216	0	181	-188	-297	142	0	0
June	25,166	4,700	315	582	2,252	33,015	-246	-472	0	123	-199	-23	325	0	0
July	25,591	5,040	309	588	2,276	33,804	789	100	0	356	-175	240	268	0	0
August	26,289	5,243	312	615	2,571	35,030	1,226	247	0	236	-95	448	390	0	0
September	25,575	4,629	335	616	3,064	34,219	-811	-1,464	0	362	-127	10	-1	0	409
October	26,423	4,576	308	610	3,038	34,955	736	551	0	385	-91	-168	59	0	0
November	26,116	4,621	305	619	2,924	34,585	-370	-34	0	-86	-158	-91	85	0	-86
December	26,329	4,155	291	614	2,859	34,248	-337	-215	0	-162	-120	-142	302	0	0

1. Gold valuation is based on the London p.m. fix on the last business day of the reporting month.
2. SDR-denominated assets are valued in U.S. dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
3. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.
4. Return on investments is comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates.
5. Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.
6. Other transactions covers increased support for IMF lending operations.

Exchange Fund Account

Financial Statements

December 31, 2001

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

David A. Dodge
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey
Chief Accountant
Bank of Canada

AUDITOR GENERAL OF CANADA

VÉRIFICATEUR GÉNÉRAL DU CANADA

AUDITOR'S REPORT

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 2001 and the statement of revenue for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 2001 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

John Wiersema, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 15, 2002

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 2001

	2001		2000	
	(in millions of dollars)			
	US	Canadian	US	Canadian
ASSETS				
Denominated in US dollars				
Cash and short-term deposits	$ 4,073	$ 6,487	$ 4,240	$ 6,358
Marketable securities (Notes 4 and 5)	15,134	24,105	16,089	24,126
	19,207	30,592	20,329	30,484
Denominated in other foreign currencies				
Cash and short-term deposits (Note 6)	108	172	146	219
Marketable securities (Notes 4 and 6)	10,541	16,790	7,176	10,747
	10,649	16,962	7,313	10,966
Denominated in Special Drawing Rights				
Special Drawing Rights (Note 7)	616	982	579	868
Gold and gold loans (Note 8)	47	75	54	81
	663	1,057	633	949
Official international reserve assets	$ 30,519	$ 48,611	$ 28,275	$ 42,399
DUE TO THE CONSOLIDATED REVENUE FUND				
Advances (Note 9)		$ 46,353		$ 39,870
Net revenue for the year		2,258		2,529
		$ 48,611		$ 42,399

Approved:

David A. Dodge
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

EXCHANGE FUND ACCOUNT
STATEMENT OF REVENUE

FOR THE YEAR ENDED DECEMBER 31, 2001

	2001	2000
	(in millions of Canadian dollars)	
Revenue from investments		
Marketable securities	**$ 2,318**	$ 2,292
Cash and short-term deposits	**303**	407
Special Drawing Rights	**32**	36
Gold	**7**	6
	2,660	2,741
Other revenue (loss)		
Gain on sales of gold	**50**	198
Net foreign exchange losses	**(452)**	(410)
	(402)	(212)
Net revenue for the year due to the Consolidated Revenue Fund	**$ 2,258**	$ 2,529

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to Financial Statements
December 31, 2001

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets which are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

The objectives of the Exchange Fund Account are to provide general liquidity for the government and to promote ordely conditions in the foreign exchange market for the Canadian dollar. In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling foreign exchange / buying Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

Revenue for the year is payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

2. Significant Accounting Policies

Significant accounting policies of the Account are set out below. As required by the *Currency Act*, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements. As all material changes in cash flows are evident from the financial statements, a separate statement of cash flows has not been prepared.

a) Valuation of assets

The estimated fair market value of cash and short-term deposits, which are recorded at cost and generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs including accrued interest and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and Special Drawing Rights (SDR) include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of four major currencies.

Gold and gold loans include accrued interest. Gold and gold loans are carried in the Account at a value of 35 SDR per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*.

b) ***Revenue from investments***

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Write downs of securities to their year-end market values (if applicable) are recorded as a charge to investment revenue in the year in which they occur.

c) ***Gold***

Gold sales and net gains on gold sales are recorded at settlement dates. Interest revenue from gold loans is recorded on an accrual basis and is included in revenue. Premiums received on the sales of call options on gold are recorded in revenue.

d) ***Translation of foreign currencies and SDRs***

Assets and liabilities denominated in foreign currencies and SDRs are translated into Canadian and US dollar equivalents at year-end market exchange rates, which were as follows:

	Canadian dollars	
	2001	2000
US dollar	**1.5928**	1.4995
Euro	**1.4182**	1.4086
Japanese yen	**0.01211**	0.01307
Special Drawing Rights	**1.99995**	1.95371

Foreign exchange gains or losses result from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year. Unrealized foreign exchange gains or losses on short-term currency swap arrangements with the Bank of Canada and on currency hedges are recorded in revenue as *Net foreign exchange gains (losses)*. See also Note 10.

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

e) ***Services received without charge***

The Account receives without charge administrative, custodial and fiscal agency services from the Bank of Canada. Costs related to these services are not recognized in the financial statements.

f) ***Interest-free advances***

The Account receives interest-free advances from the Consolidated Revenue Fund. Interest cost related to these advances is not recognized in the financial statements.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar, or to meet net government requirements for foreign exchange. During 2000 and 2001, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority, but not all, of Canada's official international reserves reside inside the Exchange Fund Account. The EFA accounts for approximatly 91% of Canada's official reserves.

4. Risk Management and Financial Instruments

The role of the EFA as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the EFA asset portfolio is prudently diversified with respect to credit risk, the investment guidelines specify limits on holdings by class of issuer (sovereign, agency, supranational or commercial financial institution) and type of instrument, while there are further limits on exposure to any one issuer or counter-party.

With respect to investment guidelines prescribed by the Minister of Finance, the EFA may hold debt issued in the designated currencies by highly rated sovereign governments, their agencies and by supranational organizations. Eligible issues must have an AA-rating or better from two of five designated rating agencies (S&P, Moody's, Fitch IBCA, Dominion Bond Rating Service and Canadian Bond Rating Service) one of which must be either Moody's or S&P. The EFA may also make deposits and execute other transactions with commercial financial institutions meeting the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Interest rate and foreign currency risks are minimized by matching the duration structure and the currency of the EFA's assets and the related foreign currency borrowings of the government of Canada.

Term Structure of Foreign Currency Investments

	Par Value					Unamortized Premium/Discount and	Amortized
	Under 6 months	6 to 12 months	1 to 5 years	Over 5 years	Total Par Value	Accrued Interest	Cost
				(in millions of US dollars)			
US Dollar Holdings							
Government securities	$3,201	$50	-	-	$3,251	$(18)	$3,233
Yield to Maturity	*2.86%*	*6.32%*					
Other securities	2,330	578	6,912	1,848	11,668	233	11,901
Yield to Maturity	*2.54%*	*4.71%*	*5.91%*	*6.31%*			
Total US Dollar Holdings	5,531	628	6,912	1,848	14,919	215	15,134
Other Foreign Currencies							
Euro Holdings							
Other securities	-	214	2,761	6,512	9,487	289	9,776
Yield to Maturity		*4.56%*	*4.53%*	*4.89%*			
Yen Holdings							
Government securities	-	-	380	380	760	5	765
Yield to Maturity			*0.57%*	*1.91%*			
Total Other Foreign Currencies	-	214	3,141	6,892	10,247	294	10,541
Total Assets:	$5,531	$842	$10,053	$8,740	$25,166	$509	$25,675

5. Marketable Securities Denominated in US Dollars

	2001			2000		
	(in millions of dollars)					
Securities	*Par value US*	*Amortized cost US*	*Amortized cost Canadian*	Par value US	Amortized cost US	Amortized cost Canadian
US Government	$ 3,251	$ 3,232	$ 5,148	$ 3,022	$ 3,046	$ 4,567
US Federal Agencies	7,772	7,746	12,337	4,655	4,611	6,915
Sovereign paper and International Institutions	3,896	3,894	6,203	8,244	8,146	12,214
Accrued interest	-	262	417	-	286	430
	$ 14,919	$ 15,134	$ 24,105	$ 15,921	$ 16,089	$ 24,126
Estimated market value at year-end:		$ 15,570	$ 24,799		$ 16,319	$ 24,471

Estimated market values are based on quoted market prices.

Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counter-parties in these transactions. At year-end, a portion of the Account's holdings of US Government securities consisting of US $ 2,500 million (par value) in Treasury Notes (US$ 2,825 million in 2000) is being used in securities lending operations with financial institutions.

6. Assets Denominated in Other Foreign Currencies

	Cash and Short-term Deposits			
	2001		2000	
	(in millions of dollars)			
	US	*Canadian*	US	Canadian
Euro	$ 46	$ 73	$ 76	$ 114
Japanese yen	62	99	70	105
	$ 108	$ 172	$ 146	$ 219

	Marketable Securities					
	2001			2000		
	(in millions of dollars)					
	Par Value US	Amortized cost US	Amortized cost Canadian	Par value US	Amortized cost US	Amortized cost Canadian
Euro	$ 9,487	$ 9,776	$ 15,571	$ 6,598	$ 6,729	$ 10,091
Japanese yen	760	765	1,219	436	438	656
	$10,247	$ 10,541	$ 16,790	$ 7,034	$7,167	$ 10,747
Estimated market value at year-end:		$10,618	$ 16,913		$ 7,174	$ 10,757

Estimated market values are based on quoted market prices.

7. SPECIAL DRAWING RIGHTS (SDR)

	2001		2000	
	(in millions of dollars)			
	US	Canadian	US	Canadian
Held at year-end	$ 614	$ 978	$ 574	$ 861
Accrued interest	2	4	5	7
	$ 616	$ 982	$ 579	$ 868

8. GOLD AND GOLD LOANS

During the year, the Account sold 132,119 fine ounces of gold (621,745 fine ounces in 2000).

	2001		2000	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Held at year-end				
Gold loans	**$ 41**	**$ 66**	$ 49	$ 74
Gold	**5**	**8**	5	7
Accrued interest on gold loans	**1**	**1**	-	-
	$ 47	**$ 75**	$ 54	$ 81

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

		2001		2000	
		Price per fine ounce	***Total value in millions***	Price per fine ounce	Total value in millions
Carrying value	- US	**$ 43.95**	**$ 47**	$ 45.60	$ 54
	- Canadian	**70.00**	**75**	68.38	81
Market value	- US	**276.50**	**291**	272.65	323
	- Canadian	**440.41**	**463**	408.84	484

9. DUE TO THE CONSOLIDATED REVENUE FUND (CRF) - ADVANCES

The Account is funded by advances from the CRF. Advances were limited to C$ 50 billion outstanding as of December 31 of each calendar year by Order in Council dated March 2, 2000. On April 26, 2001, an Order in Council was issued to increase the limit to C$ 60 billion. At year-end, advances from (deposits with) the CRF consisted of:

	2001	2000
	(in millions of Canadian dollars)	
US dollars	**$ 38,027**	$ 41,242
Canadian dollars	**(6,924)**	(10,798)
Euro	**15,162**	9,860
Japanese yen	**1,308**	758
Special Drawing Rights	**(1,220)**	(1,192)
	$ 46,353	$ 39,870

The proceeds of Canada's borrowings in foreign currencies and allocations of SDR by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on SDR allocations to Canada are charged directly to the CRF.

Canadian dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

10. COMMITMENTS

a) *Currency swaps*

The Account may enter into short-term currency swap arrangements with the Bank of Canada. The objective of these swaps is to assist the Bank in its cash management operations. The Account sells US dollars for Canadian dollars, with simultaneous agreements to repurchase these US dollars from the Bank on future dates at the same exchange rates in effect at the time the swaps were entered into. The maximum term of the swaps is equivalent to the term of the underlying securities; however, they are generally reversed earlier based on operational requirements of the Bank.

These swaps result in receipts of Canadian dollars by the Account, which are remitted to the Consolidated Revenue Fund. These transactions are reversed when the swaps are unwound.

At year-end, the Account had no commitment to repurchase US dollars under swap arrangements with the Bank of Canada (US $ 1,004 million in 2000. The Canadian dollar equivalent at the year-end exchange rate was $1,506 million).

b) ***Gold options and forward contracts***

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings.

Under gold options, the Account receives a premium against commitments to sell gold at predetermined prices. No gold is sold unless the holders of the options exercise their rights by the expiry dates. At year-end, the Account had commitments to sell 120,000 fine ounces of gold (no options outstanding in 2000).

Under forward contracts, the Account is committed to sell gold at predetermined prices on future dates. At year-end, the Account had outstanding commitments to sell 95,000 fine ounces of gold (20,000 fine ounces of gold in 2000) for a total value of US$ 27 million (US$ 6 million in 2000). The value dates of these contracts are February 21st, February 22nd, April 12th and April 30th, 2002.

c) ***Foreign currency contracts***

The following table presents the fair value of foreign currency contracts with contractual amounts outstanding at December 31:

	2001		2000	
	(in millions of Canadian dollars)			
	Contractual value	Fair value	Contractual value	Fair value
Forward Sales	$ 2,321	$ (14)	$2 262	$ 33
Forward Purchases	$ 2,339	$ 14	$2,298	$(34)

The estimated fair values of foreign exchange contracts are calculated using the year-end exchange rates. Foreign exchange contracts that have a positive fair value are those contracts that, if settled immediately, would result in a gain. Conversely, immediate settlement of a contract with a negative fair value would result in a loss.

ANNUAL REPORT TO PARLIAMENT
ON THE OPERATIONS OF THE
EXCHANGE FUND ACCOUNT
BY THE MINISTER OF FINANCE
AND
REPORT OF THE AUDITOR GENERAL
TO THE MINISTER OF FINANCE
ON THE EXAMINATION OF THE
ACCOUNTS AND FINANCIAL STATEMENTS
OF THE EXCHANGE FUND ACCOUNT
2002

(AUSSI DISPONIBLE EN FRANÇAIS)

INTRODUCTION

This report reviews the operations of the Exchange Fund Account ("EFA") for the 2002 calendar year and the changes in Canada's international reserve holdings against the background of developments in the foreign exchange market. The accompanying Financial Statements provide additional information on the operations of the EFA.

The Exchange Fund Account is the principal repository of Canada's official international reserves. The EFA is governed by the provisions of the *Currency Act* and is held in the name of the Minister of Finance. Foreign currency borrowings by the Government of Canada are the main source of financing of the EFA.

OBJECTIVES

The objectives of the EFA are:

- to provide general foreign-currency liquidity for the Government; and
- to provide funds to help promote orderly conditions for the Canadian dollar in the foreign exchange market.

GOVERNANCE

The Government approves the general policies related to the management of the EFA and, in particular, establishes the target level of reserves and provides an annual report to Parliament on the operations of the Account. Responsibility for the management of the EFA is jointly shared by the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, effects transactions for the Account.

The Director, Financial Markets Division (Department of Finance) and the Chief, Financial Markets Department (Bank of Canada), are responsible for the on-going management of the EFA. A Policy Committee, comprised of senior management of the Department of Finance and the Bank of Canada, meets semi-annually to review developments, approve major policy initiatives and provide guidance and accountability on the management of the Account.

The Risk Management Unit (RMU), established by the Bank of Canada to oversee the risk position of the Government of Canada, monitors and advises on the risk position of the EFA, including market, credit and liquidity risks.

KEY PRINCIPLES

The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis, based on many of the same principles used by private sector financial institutions (FIs), including prudent risk management principles.

In this regard, interest rate and currency risks are immunized to the extent possible and the net cost of carrying reserves is minimized. On the asset side, attention is paid to asset liquidity and quality, diversification and credit limits with counterparties. On the liability side, the same attention is paid to diversified means of raising funds, as well as to the cost of different sources of funds and the maturity profile of the liabilities.

Principles governing the management of the EFA include;

- There should be a sufficient amount of high-quality, highly-liquid foreign exchange reserve assets available for general liquidity purposes and to promote orderly conditions for the Canadian dollar in the foreign exchange market;
- The difference between the interest paid on the Government's foreign currency liabilities used to fund EFA assets and the interest earned on those assets should be minimized;
- Foreign reserves should be managed to immunize, as much as possible, the currency and duration risks;
- A prudent maturity structure and maturity profile should be maintained to limit refinancing needs within the context of liquidity requirements;
- Best practices with regards to risk management should be applied in the overall management of the EFA;
- Credit risk should be managed prudently through diversification of the EFA asset portfolio, with appropriate use of credit ratings, counterparty limits and collateral support; and
- Foreign currency borrowing activities (e.g. Global bonds and medium term notes) to fund EFA assets should be conducted so as to maintain Canada's reputation as a successful borrower in international capital markets.

Other key management guidelines include:

- The EFA portfolio is structured into a Liquidity Tier and an Investment Tier;
- At least 50% of the EFA's assets are denominated in U.S. dollars. The remainder of the portfolio is split among euro and yen-denominated assets;
- The EFA holds debt in the designated currencies of highly rated sovereign Governments, their agencies and supranational organizations having an A-rating or better.

RECENT DEVELOPMENTS

Risk Management

Consistent with best practices in risk management in recent years, the Government has been moving to a broad collateral management approach in the federal debt program to better manage the Government's credit risk to FI counterparties. Collateral management systems[1] are increasingly the

norm in capital markets as a way of managing credit risk.

In 2002, collateral frameworks were implemented on both the domestic and foreign sides of the Government's debt program. The Government successfully implemented a new credit framework for the investment of its domestic (Receiver General) cash balances which includes a move to collateralized investment of the cash beyond uncollateralized limits. On the foreign side, the Government put in place a collateral framework for the cross-currency swap program used to raise foreign exchange reserves in order to mitigate the Government's exposure to its swap counterparties. Under the new framework, high-quality collateral (e.g. cash, securities) must be posted by counterparties when the amount of credit risk borne by the Government exceeds specified limits.

2002 also saw the development of a new framework to move a portion of the Government's short-term US-dollar deposits to a collateralized basis. Currently the Government invests its US-dollar cash balances in unsecured bank deposits with a number of commercial banks. Under the revised framework, to be implemented in spring of 2003, the Government's portfolio of unsecured US-dollar cash deposits will be reduced and a program of investments in the repo[2] market will be implemented to collateralize a good part of the Government's short-term U.S. dollar investments.

Investment and Credit Guidelines for the EFA

In line with the implementation of collateral management frameworks for the Government's cross-currency swap program, the Government modified in 2002 its credit guidelines to accept A-rated FIs as eligible counterparties for deposits and swaps. This change will help the Government further diversify its credit risk across FI counterparties and will help improve the cost of carry of the reserve portfolio. Credit exposure to A-rated FIs will be maintained within prudent standards, consistent with best practices of comparable sovereigns and market participants.

The investment guidelines governing the management of the reserves asset portfolio were also modified in 2002 to allow a limited amount of securities of A-rated sovereigns to be held within prudent limits (previously, the Government could only invest in AA and AAA-rated sovereigns), mirroring the change to allow limited exposure to A-rated financial counterparties involved in reserves management. This change is in line with investment practices of a number of OECD sovereigns and will allow the Government to further diversify its EFA investments.

In 1999, the Government of Canada became one of the first countries to provide enhanced reserves disclosure in a manner consistent with the standards established by the International Monetary Fund and the G-10 central banks. The enhanced disclosure provides more extensive disaggregated data on countries' reserve holdings, including for example, data on off-balance sheet transactions. Initiatives to enhance international standards for reserves disclosures reflect the broad international consensus that more comprehensive and timely reserves data would help reduce the possibility of financial crises. In line with continued global efforts to increase transparency, the Government now discloses its credit and investment guidelines governing the EFA portfolio (see Annex 1).

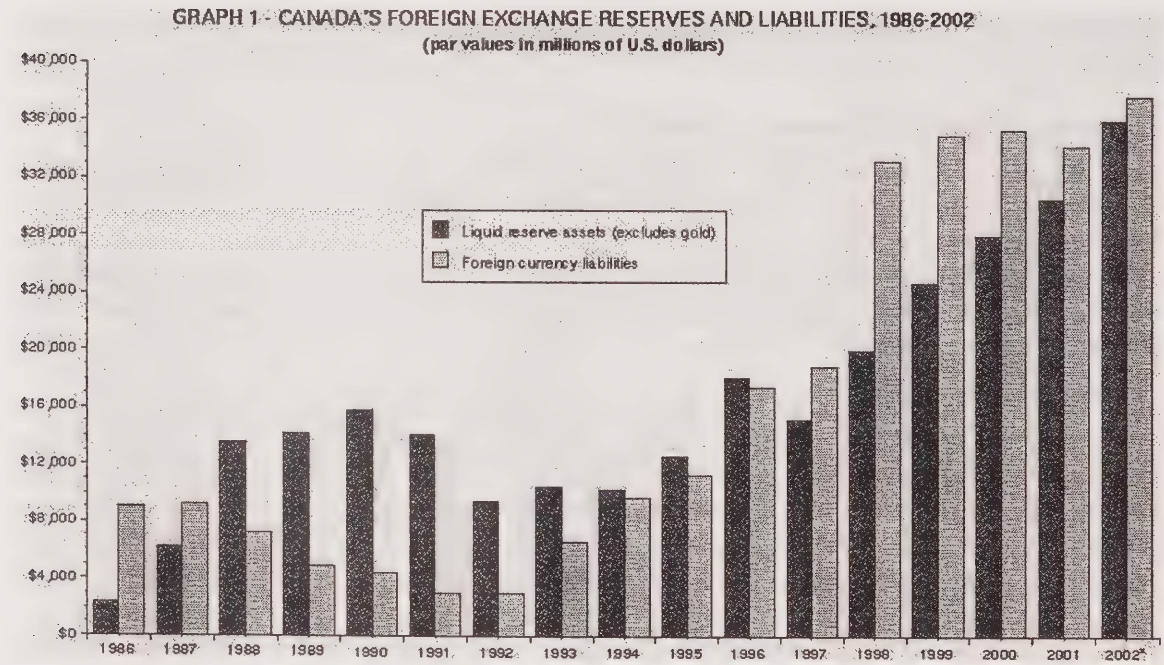
---

1. Collateral management systems involve the pledging of securities, or cash by a counterparty to another, in order to reduce the credit risk faced by the latter, should the former default.

2. Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a specific price on a specific forward date. These transactions are similar to secured loans, with the lender of money receiving securities as collateral as protection against default risk.

Asset-Liability Gap

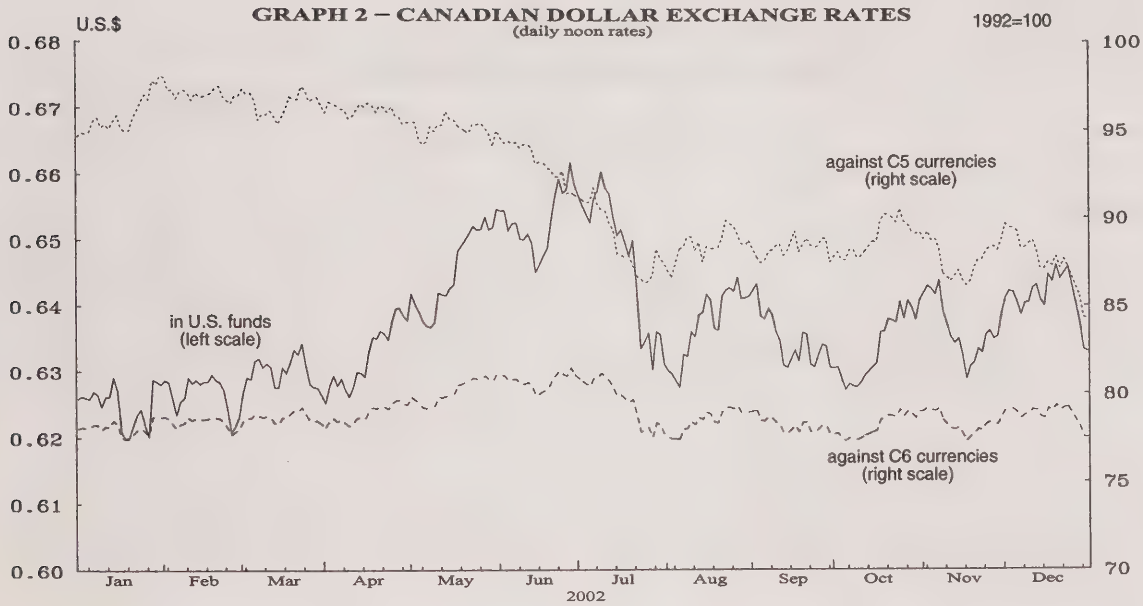
The Government of Canada's policy is to immunize currency and interest rate risk in Canada's reserve program. Foreign currency liabilities came to exceed liquid foreign currency assets (see graph 1), largely as a result of foreign exchange intervention and important commitments in the International Monetary Fund in 1998. The Government has taken steps to bring foreign currency liabilities in line with foreign currency assets through a program of purchases of U.S. dollars in foreign exchange markets. These U.S. purchases are small in relation to the large daily flows in the foreign exchange markets and are undertaken with sensitivity to market conditions. This program has reduced the gap between foreign currency assets and liabilities to some US$1.7 billion, based on market value calculations, as of the end of December 2002, and the plan is to close the gap in an orderly manner in the 2003-04 fiscal year.



* Includes assets related to IMF commitments, which are part of Canada's official international reserves. Assets and liabilities are shown at market value.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

The Canadian dollar finished 2002 relatively unchanged at US$0.6339 (up 1 per cent). The Canadian dollar's high for the year was US$0.6654 recorded on June 28 while the low for the year was US$0.6179 recorded on January 21. On a trade weighted basis, the Canadian dollar remained relatively stable against the C6[3] currencies; however, it lost more than 11 per cent against the C5 currencies (the C6 index excluding the U.S. dollar). The loss against the C5 index reflects the fact that the Canadian dollar did not appreciate as much as the other major currencies on the broad-based U.S. dollar weakening trend that started in February 2002.



3. The C6 index includes the United States, the Euro-11, Japan, the United Kingdom, Switzerland and Sweden.

FINANCIAL REVIEW

1. Foreign Exchange Market Intervention

The objectives of the Exchange Fund Account are to provide general liquidity for the Government and to promote orderly conditions in the foreign exchange market for the Canadian dollar. In September 1998, the Department of Finance and the Bank of Canada decided to move away from acting in the foreign exchange market in a predictable or automatic fashion (selling foreign exchange / buying Canadian dollars when there was downward pressure on the exchange rate, or buying foreign exchange / selling Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, current Government policy is for the Bank of Canada to act on a discretionary basis.

Since September 1998 the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of U.S. dollars versus the Canadian dollar (see Table 1).[4]

Table 1

FOREIGN EXCHANGE MARKET INTERVENTION

	1998	1999	**2000**	**2001**	**2002**
	(in millions of U.S. dollars)				
Purchases	51	0	**97**[1]	**0**	**0**
Sales	-9,063	0	**0**	**0**	**0**
Net	-9,012	0	**97**	**0**	**0**

1. Represents purchases of euros as part of Canada's participation in the G7 concerted intervention in support of the euro.

4. Official intervention is separate from net purchases of foreign currency for Government foreign exchange requirements and for additions to reserves.

2. AMOUNT AND COMPOSITION OF CANADA'S OFFICIAL INTERNATIONAL RESERVES

The Exchange Fund Account is the principal repository of Canada's official international reserves; Canada's foreign assets at the Bank of Canada and the International Monetary Fund are also included in the total of reserves. The composition of Canada's official international reserves and their distribution by holder at year end are shown below:

Table 2

CANADA'S OFFICIAL INTERNATIONAL RESERVES HOLDINGS AS AT DECEMBER 31
(market value)

			Repository			
	2001 Total	**2002 Total**[1]	Exchange Fund Account	Bank of Canada	Minister of Finance	Receiver General for Canada
	(in millions of U.S. dollars)					
Convertible foreign currencies						
Securities	26,329	**30,240**	30,240	-	-	-
Deposits	4,155	**2,445**	2,339	100	-	6
Gold	291	**205**	205	-	-	-
Reserve position in the IMF	2,859	**3,567**	-	-	3,567	-
Special drawing rights	614	**712**	712	-	-	-
Total	34,248	**37,169**	33,496	100	3,567	6

1. The classification of assets in the Statement of Official International Reserves differs from that used in the attached financial statements.

Canada's official reserves ended the year at US$37.2 billion on a market value basis. The increase in the value of reserves over this period was in large part due to the appreciation of the Euro and increases in the market value of securities. Financing activities are set out in greater detail in Table 7.

Table 3 below outlines the main factors affecting the level of reserves:

Table 3

SOURCES OF CHANGES IN CANADA'S OFFICIAL INTERNATIONAL RESERVES

(market value)

	2002 Market Value
	(millions of U.S. dollars)
Official intervention	0
Net Government operations[1]	1,400
Change in foreign currency debt	-2,374
Net cross-currency swaps	565
Gains and losses on gold sales[2]	-7
Return on investments[3]	2,245
Foreign currency debt charges	-1,528
Foreign currency revaluation	2,500
Other transactions[4]	120
Total change	2,921

1. *Net Government operations* cover net purchases of foreign currency for Government foreign exchange requirements and for additions to reserves.
2. *Gains and losses on gold sales* reflect the degree to which proceeds from the sale of gold exceeds the market value of gold that existed at the end of the previous month.
3. *Return on investments* comprises interest earned on investments and changes in the market value of securities.
4. *Other transactions* covers increased support for IMF lending operations.

More detailed information on monthly levels and changes in Canada's reserves is presented in Table 8.

3. Term Structure of EFA Investments and Liabilities

Table 4 shows EFA investments and foreign currency liabilities funding EFA assets by currency and term to maturity. Over 50% of the EFA investments are denominated in U.S. dollars.

Table 4

TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS AND LIABILITIES AS AT DECEMBER 31, 2002

(par values[1] in millions of U.S. dollars)

Term	Foreign currency investments: Cash and term deposits	Government securities in domestic currency	Other securities	Total assets	Foreign currency liabilities[2],
US DOLLAR HOLDINGS					
Under 6 months	2,529	3,125	3,177	8,831	12,849
6 to 12 months	-	-	30	30	-
1 to 5 years	-	-	5,317	5,317	5,571
Over 5 years	-	-	2,717	2,717	2,725
EURO HOLDINGS[3]					
Under 6 months	65	-	106	171	142
6 to 12 months	-	-	315	315	441
1 to 5 years	-	-	4,558	4,558	4,438
Over 5 years	-	-	7,658	7,658	7,740
YEN HOLDINGS					
Under 6 months	69	-	-	69	67
6 to 12 months	-	-	-	-	-
1 to 5 years	-	421	-	421	421
Over 5 years	-	421	-	421	421
TOTAL	**2,663**	**3,967**	**23,878**	**30,508**	**34,815**

1. Data in this table reflect the par value of all investments and liabilities. In the attached Financial Statements, investments are reported at their book value which includes unamortized premiums or discounts where applicable and accrued interest.
2. The December 31, 2002 exchange rate was used for the euro and yen assets and liabilities.
3. The liability data fully reflect the impact of the Government's long-term interest rate and currency swaps. For example, US$8,532 million of the US$12,761 million Euro liabilities consist of swapped domestic issues.

4. The Exchange Fund Account's Revenues

The Exchange Fund Account's revenues include income from its investments, net gains on sales of gold, and foreign exchange gains or losses on its assets and liabilities. In 2002, the EFA's income totalled C$2,728 million, compared with C$2,258 million in 2001.

The main categories of income earned by the EFA are summarized below:

Table 5

EXCHANGE FUND ACCOUNT INCOME SUMMARY

	1998	1999	2000	2001	**2002**
	(in millions of Canadian dollars)				
INVESTMENT INCOME					
Marketable securities	1,364	533	2,292	2,318	**2,110**
Cash and short-term deposits	257	237	407	303	**91**
Special drawing rights	69	33	36	32	**23**
Gold	26	14	6	7	**4**
Total Investment Income	1,716	817	2,741	2,660	**2,228**
OTHER INCOME					
Gains on gold sales	253	247	198	50	**175**
Foreign exchange gains (losses)	(313)	871	(410)	(452)	**325**
TOTAL INCOME	1,656	1,935	2,529	2,258	**2,728**

The EFA's securities lending programs enhance the yield earned on its securities portfolio by lending out to counterparties securities which are highly sought after in the market. At year end, $2,200 million (par value) in U.S. Government securities were held by financial institutions that act as agents for lending these securities to market participants. Income from securities lending was US$0.6 million in 2002 compared to US$1.5 million in 2001.

The EFA lends gold in the market on a short term basis, occasionally using forward rate agreements in order to benefit from occasional upward fluctuations in rates offered on gold loans. Income from this activity is reported as investment income on gold.

5. THE EXCHANGE FUND ACCOUNT'S CARRY

The Exchange Fund Account's carry is estimated by subtracting the interest paid on Canada's foreign currency liabilities from interest earned on the EFA's assets (i.e. the net interest earned or paid). In 2002, the net interest earned totalled US$15.6 million. Table 6 provides an estimate of the carry for the EFA portfolio as a whole and for the euro, yen, and U.S. dollar segments of the portfolio. The carry of the total EFA portfolio in 2002 is estimated at 5 basis points. On an individual portfolio basis, the carry for the euro portfolio is higher than that of the US dollar and yen portfolios, reflecting the comparative funding and investment opportunities in the euro market.

Carry for the EFA, Year 2002[5]:

Table 6

Carry for the EFA

	Interest Earned on Assets	Interest Paid on Liabilities	Net Interest Earned on Assets	Average Value of Assets	Carry in basis point[1]
		(in millions of U.S. dollars)			
Euro Portfolio	575.1	534.8	40.3	11,411.4	+12
Yen Portfolio	9.9	10	(0.1)	868.1	0
US$ Portfolio					
Matched	716.6	786.9	(70.3)	18,530.0	-20
Unmatched[2]	103.9	58.1	45.8	3,795.3	+13
Total	1,405.5	1,389.8	15.7	34,604.8	+5

1. The carry figures show the contribution of each currency portfolio to the overall carry of the EFA.
2. As the EFA is currently in a net foreign currency liability position, a portion of liabilities cannot be matched to any foreign currency assets. To estimate the interest income earned on the unmatched portion of the portfolio, note that sales of foreign currency assets to support the Canadian dollar on foreign exchange markets produce Canadian dollar cash which substitute for Canadian dollar borrowings. The interest paid on short-term Canadian-dollar liabilities over the same period are used to estimate the interest earned on the unmatched portion of the US-dollar portfolio. Higher short-term interest rates in Canada relative to the U.S. over the year resulted in a positive carry for the unmatched portion of the US-dollar portfolio.

The main strategies used to enhance the carry of the EFA have been, on the liability side, to achieve cost-effective funding of the reserves and, on the asset side, to take advantage of market opportunities while keeping the Account invested in liquid high-quality fixed-income securities. The EFA's carry has been further enhanced by proceeds derived from the Government's active securities lending program.

---

5. ***Interest earned on the euro, yen, and U.S. dollar matched portfolios*** includes actual and accrued interest and amortization of premium/discount. ***Interest earned on the unmatched U.S. dollar portfolio*** is the U.S. dollar equivalent of the Canadian dollar advance to the CRF multiplied by a weighted average of Government of Canada treasury bill rates prevailing in 2002. ***Interest paid on liabilities*** includes actual and accrued interest but does not include a relatively small amount of amortization.

6. Financing of EFA Assets

EFA foreign currency reserves are financed by foreign currency borrowings by the Government (see Table 7). Currently, all foreign currency marketable assets are matched to foreign currency borrowings. In addition, as noted before, because of heavy intervention in support of the Canadian dollar in 1998, there are currently more foreign currency liabilities than foreign currency assets (i.e. a portion of foreign currency liabilities is not matched by foreign currency assets).

Table 7

FOREIGN CURRENCY ISSUES
AS AT DECEMBER 31
(par values)[1]

(in millions of U.S. dollars)	2000	2001	**2002**
Bonds	13,522	12,555	**11,410**
Canada Bills	3,776	2,686	**1,712**
Swapped domestic issues	14,325	16,608	**18,378**
Floating Rate Note	-	-	**-**
Canada Notes	638	928	**842**
Euro Medium Term Notes	2,988	2,571	**2,161**
TOTAL	35,249	35,348	**34,503**

1. Liabilities are stated at historical FX rates.

7. Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks, related to the financing and investment of the foreign exchange reserves.[6] The Government's risk management policies call for prudent management of treasury risks based on best practices. Standards for risk tolerance are very prudent, with market risks generally immunized and high credit quality and diversification standards followed.

The governance framework separates risk management from treasury operations. The Risk Management Unit (RMU) established by the Department of Finance and the Bank of Canada monitors and advises on the risk position of the EFA. The RMU measures the EFA's major treasury risks on a daily basis and reports regularly to both treasury and senior management at the Department of Finance and the Bank of Canada.

The Risk Management Committee (RMC) meets regularly to review risk reports and to provide guidance and accountability on the Government's treasury risk policies. The Committee is comprised of senior treasury management from the Department of Finance and the Bank of Canada and also includes members from the Department of Finance and the Bank of Canada outside treasury operations.

6. For more information on the Government risk management framework, see article published in the winter 2001-02 edition of the Bank of Canada Review.

Table 8

CANADA'S OFFICIAL INTERNATIONAL RESERVES
(market value in millions of U.S. dollars)

Month-to-Month Changes

Month End	Securities	Deposits	Gold[1]	Special Drawing Rights[2]	Reserve Position in the IMF[2 3]	Total	Total Monthly Change	Reserve Management Operations [4]	Gains and Losses on Gold Sales	Return on Investments[5]	Foreign Currency Debt Charges	Revaluation Effects	Net Government Operations[6]	Official Intervention	Other transactions[7]
2001															
December	26,329	4,155	291	614	2,859	34,248	-337	-215	0	-162	-120	-142	302	0	0
2002															
January	26,589	3,325	297	607	2,826	33,644	-604	-139	0	34	-82	-394	-23	0	0
February	26,764	3,595	284	619	2,918	34,180	536	320	0	126	-96	144	-48	0	90
March	27,298	2,876	288	621	2,946	34,029	-151	128	0	-229	-93	47	1	0	-5
April	27,915	3,336	266	632	2,807	34,956	927	211	-2	348	-79	450	-1	0	0
May	28,320	3,588	281	655	2,832	35,676	720	210	0	111	-109	513	-1	0	-4
June	29,358	3,473	274	675	3,410	37,190	1,514	44	0	320	-147	882	415	0	0
July	28,591	3,599	262	671	3,287	36,410	-780	-987	0	413	-159	-211	171	0	-7
August	29,179	3,588	242	688	3,399	37,096	686	188	-1	283	-101	100	126	0	91
September	29,478	2,885	250	686	3,316	36,615	-481	-987	0	430	-214	32	254	0	4
October	29,873	3,172	216	685	3,310	37,256	641	616	-3	-22	-196	15	227	0	4
November	29,681	2,640	218	697	3,265	36,501	-755	-721	0	-13	-57	67	22	0	-53
December	30,240	2,445	205	712	3,567	37,169	668	-692	-1	444	-195	855	257	0	0

1. Gold valuation is based on the London p.m. fix on the last business day of the reporting month.
2. SDR-denominated assets are valued in U.S. dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the U.S. dollar generates an increase in the U.S. dollar value of Canada's holdings of SDR-denominated assets.
3. The reserve position in the IMF represents the amount of foreign exchange which Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.
4. Net change in Securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increase reserves, while maturities decrease reserves).
5. Return on investments is comprised of interest earned on investments and changes in the market value of securities resulting from changes in interest rates.
6. Net Government operations are the net purchases of foreign currency for Government foreign exchange requirements and for additions to reserves.
7. Other transactions covers increased support for IMF lending operations.

Annex 1: Investment and Credit Guidelines for the EFA

I. Eligible Issuers

To be eligible for EFA investments, an entity must have a credit rating in the top seven long-term categories from at least two of the following four rating agencies, at least one of which must be either Moody's or S&P:

Ratings Agency	Minimum Rating
Moody's	A3 or better
S&P	A- or better
Fitch	A- or better
Dominion Bond Rating Service	A(low) or better

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of S&P.

II. Aggregate and Individual Limits on Holdings

a) Sovereigns and Directly Guaranteed Agencies

Type of Issuer	Aggregate Category Limits (as % of liquid reserves)	Individual Counter-party Limits (as % of liquid reserves)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies)	25	10
AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
Single A sovereigns (including directly guaranteed agencies)	2	See below*

*The limits for single A sovereigns (including directly guaranteed agencies) in US$ millions are as follows:

Credit Rating	Total Exposure	Of Which Home Currency	Of Which Non-Home Currency
A+	500	500	50
A	250	250	25
A-	100	100	10

b) Other Eligible Securities/Deposits

Type of Issuer/Financial Institution	Aggregate Category Limits (as % of liquid reserves)	Individual Counter-party Limits (as % of liquid reserves)
Implicitly guaranteed sovereign agencies (including eligible US Agencies)	15	3
Supranationals (not including deposits at the BIS)	25	10
Deposits at the BIS	10	--
Commercial bank deposits	US$ 1.5 billion	See limits below

III. Financial Institution (FI) Counterparty Credit Risk Limits

a) For Swaps, Deposits and Forwards

Type of Exposure (US$M)	Credit Rating of FI Counterparty						
	A-	A	A+	AA-	AA	AA+	AAA
Actual Exposure	10	25	50	100	150	200	300
Aggregate Actual Exposure for all FI counterparties	2% of liquid reserves			N/A			
	25% of liquid reserves						
Potential Exposure*	10	25	50	200	200	200	200
Total Potential Exposure for all FI Counterparties	1,250						

*Potential exposure on swaps and forwards is calculated based on BIS guidelines.

b) For Repo Transactions

Minimum credit rating for a counterparty	A-	
Business line limits for counterparties, by credit rating	AAA	US$ 750M
	AA	US$ 500M
	A	US$ 300M
Eligible collateral	US Treasuries and Agencies	
Minimum rating for collateral	AAA	
Maximum term of collateral	10.5 years	

IV. Terms of Investments

Instrument	Maximum Term
Commercial bank deposits and other non-marketable investments	3 months
Commercial bank marketable investments	1 year
All other marketable securities	10.5 years (unless matching a specific liability that exceeds 10.5 years)

V. Liquidity Limits

Minimum holdings of US Treasuries	10% of liquid reserves
Minimum issue size	US$ 500M
Maximum holding of any issue/note program/CP program	10% of the issue/note program/CP program
Maximum non-marketable investments beyond 5 days in term	15% of liquid reserves

VI. Currency Composition

Currency	% of Liquid Reserves
US dollar	Minimum of 50
Euro and/or Yen	Up to 50

EXCHANGE FUND ACCOUNT

FINANCIAL STATEMENTS

DECEMBER 31, 2002

Management Responsibility for the Financial Statements

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

The Department of Finance establishes policies for the Account's transactions and investments, and related accounting activities. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

David A. Dodge
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey
Chief Accountant
Bank of Canada

Auditor General of Canada
Vérificatrice générale du Canada

AUDITOR'S REPORT

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at December 31, 2002 and the statement of revenue for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at December 31, 2002 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

John Wiersema, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
March 14, 2003

EXCHANGE FUND ACCOUNT
BALANCE SHEET

AS AT DECEMBER 31, 2002

	2002		2001	
	(in millions of dollars)			
	US	**Canadian**	US	Canadian
ASSETS				
Denominated in US dollars				
Cash and short-term deposits	**$ 2,529**	**$ 3,990**	$ 4,073	$ 6,487
Marketable securities (Notes 4 and 5)	**14,635**	**23,088**	15,134	24,105
	17,164	**27,078**	19,207	30,592
Denominated in other foreign currencies				
Cash and short-term deposits (Note 6)	**134**	**211**	108	172
Marketable securities (Notes 4 and 6)	**13,899**	**21,928**	10,541	16,790
	14,033	**22,139**	10,649	16,962
Denominated in Special Drawing Rights				
Special Drawing Rights (Note 7)	**719**	**1,134**	616	982
Gold and gold loans (Note 8)	**28**	**45**	47	75
	747	**1,179**	663	1,057
Official international reserve assets	**$ 31,944**	**$ 50,396**	$ 30,519	$ 48,611
DUE TO THE CONSOLIDATED REVENUE FUND				
Advances (Note 9)		**$ 47,668**		$ 46,353
Net revenue for the year		**2,728**		2,258
		$ 50,396		$ 48,611

Approved:

David A. Dodge
Governor
Bank of Canada

Kevin G. Lynch
Deputy Minister
Department of Finance

S. Vokey
Chief Accountant
Bank of Canada

(The accompanying notes are an integral part of these financial statements.)

EXCHANGE FUND ACCOUNT
STATEMENT OF REVENUE

FOR THE YEAR ENDED DECEMBER 31, 2002

	2002	2001
	(in millions of Canadian dollars)	
Revenue from investments		
Marketable securities	**$ 2,110**	$ 2,318
Cash and short-term deposits	**91**	303
Special Drawing Rights	**23**	32
Gold	**4**	7
	2,228	2,660
Other revenue (loss)		
Gain on sales of gold	**175**	50
Net foreign exchange gains(losses)	**325**	(452)
	500	(402)
Net revenue for the year due to the Consolidated Revenue Fund	**$ 2,728**	$ 2,258

(The accompanying notes are an integral part of these financial statements.)

EXCHANGE FUND ACCOUNT

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2002

---

1. AUTHORITY AND OBJECTIVE

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar, and the Minister of Finance acquires or sells for the Account those assets which are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the *Act*.

The objectives of the Exchange Fund Account are to provide general liquidity for the government and to promote orderly conditions in the foreign exchange market for the Canadian dollar. In September 1998, the Department of Finance and the Bank of Canada decided to move away from intervening in the foreign exchange market in a predictable or automatic fashion (selling foreign exchange / buying Canadian dollars when there was upward pressure on the value of the Canadian dollar). Instead, the current policy is for the Bank of Canada to intervene on a discretionary basis.

Revenue for the year is payable to the Consolidated Revenue Fund of the Government of Canada within three months after the end of the year in accordance with the *Currency Act*.

2. SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies of the Account are set out below. As required by the *Currency Act*, they conform to the stated accounting policies used by the Government of Canada to prepare its financial statements. As all material changes in cash flows are evident from the financial statements, a separate statement of cash flows has not been prepared.

a) Valuation of assets

The estimated fair market value of cash and short-term deposits, which are recorded at cost and generally held to maturity, is deemed to be equal to their book value.

Marketable securities are adjusted for unamortized premiums or discounts, where applicable, and are reported at the lower of their amortized costs including accrued interest and year-end market values. Purchases and sales of securities are recorded at the settlement dates.

Marketable securities, short-term deposits and Special Drawing Rights (SDR) include accrued interest. The SDR is a unit of account issued by the International Monetary Fund (IMF), and its value is determined in terms of a basket of four major currencies.

Gold and gold loans include accrued interest. Gold and gold loans are carried in the Account at a value of 35 SDR per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*.

b) ***Revenue from investments***

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, gains or losses on sales of securities, and revenues from securities lending activities. Write downs of securities to their year-end market values (if applicable) are recorded as a charge to investment revenue in the year in which they occur.

c) ***Gold***

Gold sales and net gains on gold sales are recorded at settlement dates. Interest revenue from gold loans is recorded on an accrual basis and is included in revenue. Premiums received on the sales of call options on gold are recorded in revenue.

d) ***Translation of foreign currencies and SDRs***

Assets and liabilities denominated in foreign currencies and SDRs are translated into Canadian and US dollar equivalents at year-end market exchange rates, which were as follows:

	Canadian dollars	
	2002	2001
US dollar	**1.5776**	1.5928
Euro	**1.6568**	1.4182
Japanese yen	**0.01328**	0.01211
Special Drawing Rights	**2.13699**	1.99995

Foreign exchange gains or losses result from the translation of assets and advances denominated in foreign currencies and SDRs, as well as transactions throughout the year. Unrealized foreign exchange gains or losses on forward currency contracts are recorded in revenue as *Net foreign exchange gains(losses).*

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

e) ***Services received without charge***

The Account receives without charge administrative, custodial and fiscal agency services from the Bank of Canada. Costs related to these services are not recognized in the financial statements.

f) ***Interest-free advances***

The Account receives interest-free advances from the Consolidated Revenue Fund. Interest cost related to these advances is not recognized in the financial statements.

3. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar, or to meet net government requirements for foreign exchange. During 2001 and 2002, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority, but not all, of Canada's official international reserves reside inside the Exchange Fund Account. The EFA accounts for approximately 90% of Canada's official reserves.

4. Risk Management and Financial Instruments

The role of the EFA as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

To ensure that the EFA asset portfolio is prudently diversified with respect to credit risk, the investment guidelines specify limits on holdings by class of issuer (sovereign, agency, supranational or commercial financial institution) and type of instrument, while there are further limits on exposure to any one issuer or counter-party.

With respect to investment guidelines prescribed by the Minister of Finance, the EFA may hold debt issued in the designated currencies by highly rated sovereign governments, their agencies and by supranational organizations. Eligible issues must have an A-rating or better from two of four designated rating agencies (S&P, Moody's, Fitch, and Dominion Bond Rating Service) one of which must be either Moody's or S&P. The EFA may also make deposits and execute other transactions with commercial financial institutions meeting the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

Interest rate and foreign currency risks are managed by adopting a strategy of matching the duration structure and the currency of the EFA's assets and the related foreign currency borrowings of the government of Canada.

TERM STRUCTURE OF FOREIGN CURRENCY INVESTMENTS

	2002						2001
			Par Value		Unamortized Premium/Discount and Accrued Interest	Amortized Cost	Amortized Cost
	Under 6 months	6 to 12 months	1 to 5 years	Over 5 years			
			(in millions of US dollars)				
US Dollar Holdings							
Government securities	$ 3,125	$ -	$ -	$ -	$ (11)	$ 3,114	$ 3,233
Yield to Maturity	*1.52%*						
Other securities	3,177	30	5,317	2,717	280	11,521	11,901
Yield to Maturity	*1.37%*	*2.46%*	*5.51%*	*5.48%*			
Total US Dollar Holdings	6,302	30	5,317	2,717	269	14,635	15,134
Other Foreign Currencies							
Euro Holdings							
Other securities	106	315	4,558	7,658	416	13,053	9,776
Yield to Maturity	*4.47%*	*4.89%*	*4.48%*	*4.85%*			
Yen Holdings							
Government securities	-	-	421	421	4	846	765
Yield to Maturity			*0.57%*	*1.91%*			
Total Other Foreign Currencies	106	315	4,979	8,079	420	13,899	10,541
Total Assets:	$ 6,408	$ 345	$10,296	$ 10,796	$ 689	$ 28,534	$ 25,675

5. Marketable Securities Denominated in US Dollars

	2002			2001		
	(in millions of dollars)					
Securities	***Par value***	***Amortized cost***		Par value	Amortized cost	
	US	***US***	***Canadian***	US	US	Canadian
US Government	**$ 3,125**	**$ 3,114**	**$ 4,913**	$ 3,251	$ 3,232	$ 5,148
US Federal Agencies	**4,366**	**4,415**	**6,965**	7,772	7,746	12,337
Sovereign paper and International Institutions	**6,875**	**6,901**	**10,886**	3,896	3,894	6,203
Accrued interest	**-**	**205**	**324**	-	262	417
	$ 14,366	**$ 14,635**	**$ 23,088**	$ 14,919	$ 15,134	$ 24,105
Estimated market value at year-end:		**$ 15,316**	**$ 24,163**		$ 15,570	$ 24,799

Estimated market values are based on quoted market prices.

Loans of securities are effected on behalf of the Account by agents who guarantee the loans and obtain collateral of equal or greater value from their approved counter-parties in these transactions. At year-end, a portion of the Account's holdings of US Government securities consisting of US$ 2,200 million (par value) in Treasury Bills (US$ 2,500 million in 2001) is being used in securities lending operations with financial institutions.

6. Assets Denominated in Other Foreign Currencies

	Cash and Short-term Deposits			
	2002		2001	
	(in millions of dollars)			
	US	***Canadian***	US	Canadian
Euro	**$ 65**	**$ 102**	$ 46	$ 73
Japanese yen	**69**	**109**	62	99
	$ 134	**$ 211**	$ 108	$ 172

	Marketable Securities					
	2002			2001		
	(in millions of dollars)					
	Par Value US	Amortized cost US	Amortized cost Canadian	Par value US	Amortized cost US	Amortized cost Canadian
Euro	$ 12,637	$ 13,053	$ 20,593	$ 9,487	$ 9,776	$ 15,571
Japanese yen	842	846	1,335	760	765	1,219
	$ 13,479	$ 13,899	$ 21,928	$ 10,247	$10,541	$ 16,790
Estimated market value at year-end		$ 14,597	$ 23,028		$ 10,618	$ 16,913

Estimated market values are based on quoted market prices.

7. SPECIAL DRAWING RIGHTS (SDR)

	2002		2001	
	(in millions of dollars)			
	US	Canadian	US	Canadian
Held at year-end	$ 717	$ 1,130	$ 614	$ 978
Accrued interest	2	4	2	4
	$ 719	$ 1,134	$ 616	$ 982

8. Gold and Gold Loans

During the year, the Account sold 452,516 fine ounces of gold (132,119 fine ounces in 2001).

	2002		2001	
	(in millions of dollars)			
	US	Canadian	US	Canadian
Held at year-end				
Gold loans	$ 23	$ 37	$ 41	$ 66
Gold	5	8	5	8
Accrued interest on gold loans	0	0	1	1
	$ 28	$ 45	$ 47	$ 75

The year-end carrying values and market values (based on London fixings) of gold and gold loans, excluding accrued interest, are:

		2002		2001	
		Price per fine ounce	Total value in millions	Price per fine ounce	Total value in millions
Carrying value	- US	$ 47.41	$ 28	$ 43.95	$ 47
	- Canadian	74.79	45	70.00	75
Market value	- US	347.20	208	276.50	291
	- Canadian	547.74	328	440.41	463

9. Due to the Consolidated Revenue Fund (CRF) - Advances

The Account is funded by advances from the CRF. These are limited to C$ 60 billion by Order in Council dated April 26, 2001. At year-end, advances from (deposits with) the CRF consisted of:

	2002	2001
	(in millions of Canadian dollars)	
US dollars	**$ 32,852**	$ 38,027
Canadian dollars	**(5,447)**	(6,924)
Euro	**20,132**	15,162
Japanese yen	**1,435**	1,308
Special Drawing Rights	**(1,304)**	(1,220)
	$ 47,668	$ 46,353

The proceeds of Canada's borrowings in foreign currencies and allocations of SDR by the IMF have been advanced from the CRF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances. Interest payable by Canada on borrowings in foreign currencies and charges on SDR allocations to Canada are charged directly to the CRF.

Canadian dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

10. Commitments

a) *Currency swaps*

The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash management operations. There were no drawings under this facility in 2002 or 2001 and there were no commitments outstanding as at December 31, 2002 nor at December 31, 2001.

b) ***Gold options and forward contracts***

The Minister of Finance has authorized the sale of call options, as well as forward sales, on part of the Account's gold holdings.

Under gold options, the Account receives a premium against commitments to sell gold at predetermined prices. No gold is sold unless the holders of the options exercise their rights by the expiry dates. At year-end, the Account had commitments to sell 20,000 fine ounces of gold (120,000 fine ounces in 2001).

Under forward contracts, the Account is committed to sell gold at predetermined prices on future dates. At year-end, the Account had outstanding commitments to sell 205,516 fine ounces of gold (95,000 fine ounces of gold in 2001) for a total value of US$ 66 million (US$ 27 million in 2001). The value dates of these contracts are February 24th, April 11th and June 24th, 2003.

c) ***Foreign currency contracts***

The following table presents the fair value of foreign currency contracts with contractual amounts outstanding at December 31:

	2002		2001	
	(in millions of Canadian dollars)			
	Contractual Value	**Fair Value**	Contractual value	Fair value
Forward Sales	**$ 2,975**	**$ (29)**	$ 2,321	$ (14)
Forward Purchases	**$ 2,991**	**$ 29**	$ 2,339	$ 14

The estimated fair values of foreign exchange contracts are calculated using the year-end exchange rates. Foreign exchange contracts that have a positive fair value are those contracts that, if settled immediately, would result in a gain. Conversely, immediate settlement of a contract with a negative fair value would result in a loss.